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TRADE DEFICIT—II

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

JUNE 28, 1984

PART 2 of 2

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TRADE DEFICIT

THURSDAY, JUNE 28, 1984

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:12 a.m. in room SD-215, Dirksen Senate Office Building, Hon. John Danforth presiding.

Present: Senators Chafee, Danforth, Long, and Bentsen.

[The press release announcing the hearing follows:]

[Press Release No. 84-150]

FINANCE COMMITTEE ANNOUNCES HEARING ON THE TRADE DEFICIT

Senator Robert J. Dole (R., Kans.), chairman of the Committee on Finance, announced today that a hearing will be held on Thursday, June 28, 1984, on the trade deficit.

The hearing will begin at 10 a.m. in room SD-215 of the Dirksen Senate Office Building.

In announcing the hearing Senator Dole stated, "At the time of our March 23 hearing on the trade deficit, our trade deficit was accumulating at the annual rate of about $100 billion. Now the rate has accelerated to $140 billion, and there is every prospect that these unprecedented figures will be repeated next year.

"Although the administration testified that the trade deficit reflects macroeconomic forces beyond its control, we are anxious to hear the business community's views on this important issue in hopes of taking practical steps to reduce the trade deficit. All defenders of the international trading system should be concerned over the threat to that system generated by the continuation of these massive imbalances."

Senator **DANFORTH**. Chairman Dole has scheduled this hearing on a subject which is obviously very topical, that is, the mounting trade deficit that the United States is experiencing. There are at least a couple of views on the seriousness of the trade deficit. Some people tend to downplay it. I think most of us in Congress view a $150 billion or so annual trade deficit as something very serious for our country, and something that does have negative impact on the American economy and those people whose jobs are being lost because of the fact that the United States is not exporting as much as it is importing.

The fact that we have a $150 billion trade deficit raises a question as to what to do about it. One approach might be an effort to fix the present trade system, to mend it where it is broken. Another approach, which I find more and more people discussing, is to ask the question whether the system is really fixable or whether the time has come to take a whole new look at the way the United States does business with other countries. Perhaps the approach that we have been following for the last couple of decades or so is simply wrong now and doesn't serve the best interest of the United States, and maybe we should take a whole new look at trade policy from scratch.

So this hearing, I think, is very timely, and we have an excellent group of witnesses. The first person on the list is Mr. John J. Nevin, who is the chairman and chief executive officer of Firestone Tire & Rubber Co.

Mr. Nevin, thank you for being here.

STATEMENT OF JOHN J. NEVIN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE FIRESTONE TIRE & RUBBER CO., AKRON, OH

Mr. NEVIN. Mr. Chairman, my name is John J. Nevin. I'm chairman of the board of Firestone Tire & Rubber Co. I'm pleased to have this opportunity to testify this morning. But I should note the views I will express are my own and not necessarily shared by either businessmen in other industries or my associates in the tire industry.

Deficits in foreign trade are a recent phenomenon in American history. During the 25 years from 1946 through 1970, there was no year in which the United States reported a merchandize trade deficit. Since the 1973 oil crisis, however, this country has incurred huge and growing trade deficits. During the 6 year 1977 to 1982 period, those deficits averaged $40.1 billion a year. Today the United States is incurring trade deficits at a rate approximating $140 billion a year.

The increase in the U.S. merchandise trade deficit from the $40 billion annual rate experienced during the 1977 to 1982 period to the $140 billion annual rate currently being experienced can be expected to reduce U.S. tax revenues and increase social expenditures in this country by about $35 billion annually, an amount that would more than offset all of the fiscal benefits the Congress has sought to accomplish through curtailments in nondefense spending.

There is, in my view, a substantial body of evidence to support the opinion that U.S. trade deficits are having a very sizable and rapidly growing adverse impact on U.S. budget deficits. I would respectfully suggest that the adoption of courses of action that would reduce the U.S. trade deficit could contribute as importantly to reductions in U.S. budget deficits as would courses of action involving limitations on defense expenditures, curtailments of social programs or increases in taxes.

The United States has incurred huge merchandise trade deficits during a period in which its labor force was the most productive in the world, and its energy costs were the lowest in the industrialized world. It has incurred those deficits during a period in which it benefited from domestic raw material resources far greater than those of other industrialized nations, and on which its abundant agriculture made it far less dependent on imported food.

If there were free trade in the world, the United States would not today be struggling to control huge trade deficits. The world, however, does not have a free trade system. It has an administered trade system. Other nations have sought to minimize unemployment at home and earn the dollars needed to pay for imported oil by rigidly limiting imports and aggressively promoting exports.

U.S. trade policy on the other hand has continued to view the U.S. economy as being so strong as to be immune from injury regardless of the inequities that the United States accepts in international trade.

The time has come, in my opinion, for the United States to respond to all the causes of huge and growing U.S. trade deficits, which include the exclusion of U.S. products from foreign markets, an overvalued dollar, inequitable international trade conventions, and unfair trade practices, such as dumping.

If effective action is not taken, public support in the United States for protectionist measures that could seriously damage the world trade system will continue to increase and the ability of U.S. economy to support essential social and defense programs will continue to diminish.

Mr. Chairman, that concludes my oral testimony, which summarizes the view that are outlined in a somewhat more detailed written document that I would like to submit for the record. And, second, a considerable portion of my written submission is concerned with tax disadvantages in the automobile industry, and I would like to ask that you include in the record a copy of an article that I had published in the Harvard Business Review about 1 year ago concerned with that subject.

Finally, during the last several weeks, considerable press attention has been given to a consulting report that was prepared for the American International Automobile Dealers Association, which concluded that Japanese cars carry a $2,675 tax load in the United States compared with only $2,088 for a U.S. car. That study was based on a 50.5 percent Congressional Research Service estimate of Japanese taxes on return of capital, but it was used by the consultants erroneously, not as a percentage of profit or return on capital, but rather as a percentage of sale. And by misusing it and applying it as a percentage of sale, they generated about $2,000 of that $2,600 reported Japanese tax load, and I ask you, sir, if you will consider for the record a letter from the Congressional Research Service that was directed to the Honorable Donald W. Regal in which the Congressional Research Service describes the manner in which its information was inappropriately used.

Senator CHAFEE. I will be happy to have your statement for the record, and all statements will be included in the record automatically, and also the other material.

Mr. NEVIN. Thank you, sir.

[The prepared statement of Mr. Nevin and the article from Harvard Business Review follows:]

Statement of
JOHN J. NEVIN
Chairman and Chief Executive Officer
The Firestone Tire & Rubber Company
before the
COMMITTEE ON FINANCE
United States Senate
Washington, D.C.
June 28, 1984

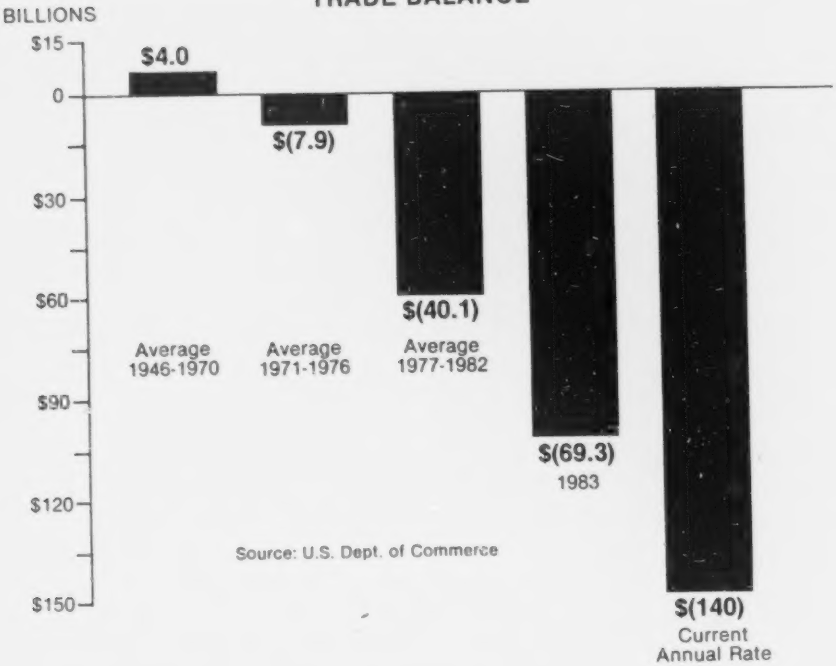
INTRODUCTION

Mr. Chairman: My name is John J. Nevin; I am Chairman of the Board of The Firestone Tire & Rubber Company.

The Committee on Finance has announced that in these hearings it wishes to consider the views of the business community on the practical steps the United States might take to reduce the huge and rapidly increasing trade deficits this nation is today incurring.

I am pleased to have this opportunity to express my opinions on this very important subject.

U. S. MERCHANDISE TRADE BALANCE



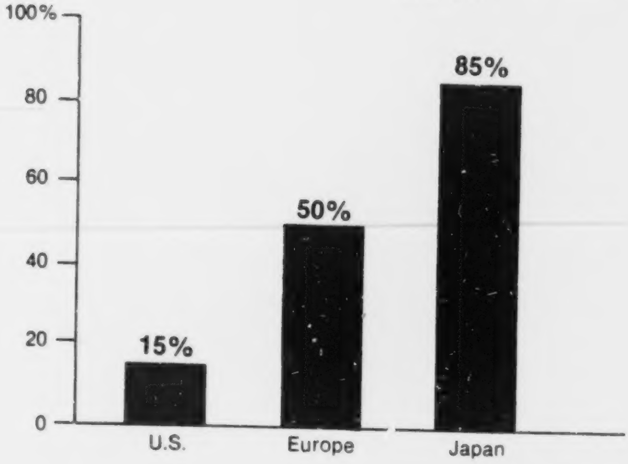
Source: U.S. Dept. of Commerce

Deficits in foreign trade are a recent phenomenon in American history. During the 25 years from 1946 through 1970, there was no year in which the United States reported a merchandise trade deficit.

Since the 1973 oil crisis, however, this country has incurred huge and growing trade deficits. During the six-year 1977-82 period, those deficits averaged $40.1 billion annually. Today the United States is incurring deficits in merchandise trade at a rate approximating $140 billion annually.

ENERGY IMPORTS AS A PERCENT OF TOTAL REQUIREMENTS

1974-1980

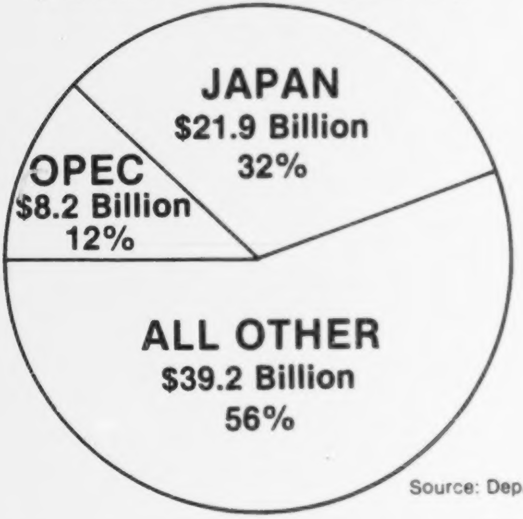


Source: Organization for Economic
Cooperation and Development

In the mid-1970s, when the U.S. first began to report huge trade deficits, many Americans were led to believe that those deficits were caused by growing imports of expensive foreign oil and that the remedy was to be found in fuel conservation.

During the 1974-80 period, however, in which the price of Saudi crude increased from $2 to $34 per barrel, it was the United States, the industrialized nation least dependent upon imported energy, that was the only industrialized nation in the world to incur huge and growing trade deficits.

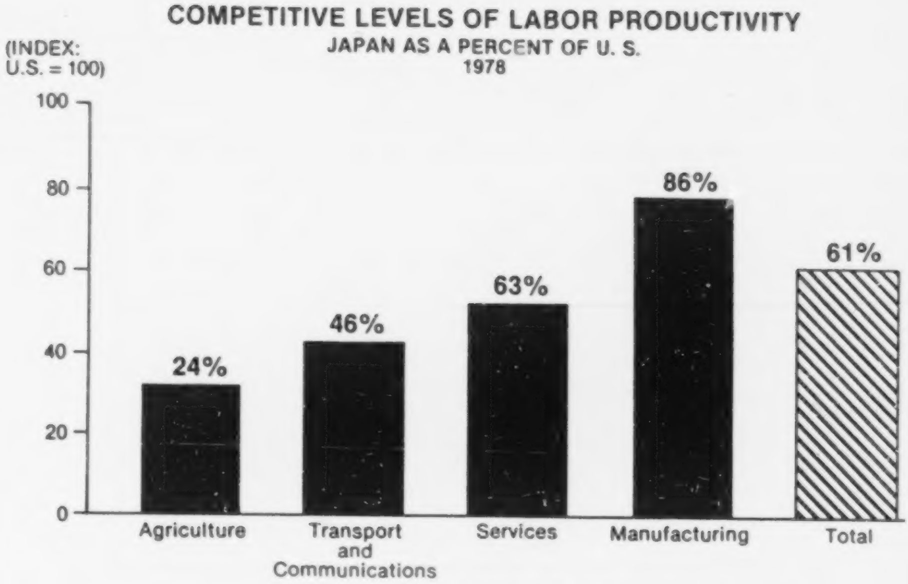
COMPOSITION OF 1983
U. S. TRADE DEFICIT
(TOTAL OF $69.3 BILLION)



Source: Department of Commerce

In 1983, the $21.9 billion deficit the United States incurred in trade with Japan accounted for almost one-third of this country's total deficit and was more than twice as large as the $8.2 billion deficit the United States incurred in trade with the 13 OPEC nations combined.

As the imbalance in U.S.-Japan trade has grown, the explanation most frequently offered for sharply increasing U.S. trade deficits has shifted from the high cost of imported oil to assertions that products produced in the United States have become non-competitive at home and abroad because American labor is today less productive than labor forces in Japan and elsewhere in the world.



COMPETITIVE LEVELS OF LABOR PRODUCTIVITY
JAPAN AS A PERCENT OF U. S.
1978

Source: Japan 1983, An International Comparison
Japan Institute for Social and Economic Affairs

In a report titled, "Japan 1983," the Japan Institute for Social and Economic Affairs has used the most recent data available from the Japan Productivity Center to compare labor productivity in the U.S. and Japan. The comparisons published by the Institute indicate that Japanese labor was less than 25 percent as productive as U.S. labor in agriculture, less than half as productive in transport and communications, less than two-thirds as productive in the service industries, and about 86 percent as productive in manufacturing as a whole.

The notion that American labor is less productive than Japanese labor has gained wide acceptance in the United States, in part, because the productivity statistics that have been given so much attention in this country measure year-to-year changes in productivity not absolute levels of productivity.

U. S. LEVELS OF MANUFACTURING SECTOR LABOR PRODUCTIVITY COMPARED WITH JAPAN

	JAPAN PERCENT OF U. S. IN 1980
Chemical Industry	89
Instruments	86
General Machinery	78
Textiles	74
Leather and Products	50
Pulp and Paper Products	48
Printing and Publishing	46
Foods	44
Apparels	39

Source: Japan 1983, An International Comparison
Japan Institute for Social and Economic Affairs

By "targeting" its financial and technical resources, Japan has achieved extraordinary levels of productivity in such export-oriented industries as automobiles, steel, and consumer electronics. Japanese productivity, however, is far below U.S. levels in most other industries.

Reducing U.S. trade deficits will require that, in those U.S. industries that are being outperformed by overseas competitors, American management and labor accept the responsiblity for attaining international levels of efficiency.

Reducing those deficits will also require, however, that the Government of the United States undertake to make certain that U.S. products with competitive advantages are not excluded from foreign markets by nations that expect their most competitive industries to be granted easy access to the U.S. market, but persist in protecting their less efficient industries from import competition.

CONSUMER ATTITUDES TOWARD MAJOR TELEVISION BRANDS

	Brand Having Highest Quality	Brand Requiring Fewest Repairs	Brand Preferred If Buying New TV Today
Zenith	32%	32%	33%
RCA	22	19	20
Magnavox	6	5	6
Sony	6	4	6
Motorola/Quasar	5	4	5
Sylvania	4	3	4
GE	3	3	3

Source: Louis Harris and Associates, Inc. (August 1978)

Several years ago, during the television importation controversy, it was often suggested that American consumers were attracted by the higher quality of Japanese offerings rather than by their lower prices. Surveys conducted by Louis Harris & Associates, Inc. and the Gallup Organization, Inc. during that period demonstrated, however, that American consumers considered the quality of receivers produced in the United States to exceed or fully equal the quality of imports.

For some Americans, it has become fashionable to disparage the quality of products produced in the United States. The people of Europe and Asia don't share this view of American workmanship. They fly vast distances in commerical aircraft built in the United States, they manage their industry and their finances with computers built in the United States, and they rely heavily on American workers for the sophisticated military hardware that they need to defend their countries.

CONSUMERS UNION
COMPARATIVE RATINGS OF MAJOR TELEVISION BRANDS (TESTS CONDUCTED FROM JAN. 1969 TO SEPT. 1978)*

		Best Possible Rating		Average Rating Or Better	
Individual Brands	**Number of Sets Tested**	**Number**	**Percent**	**Number**	**Percent**
Zenith	21	9	43%	18	86%
Sylvania	18	4	22	13	72
Sony	9	2	22	5	56
RCA	25	5	20	16	64
GE	21	4	19	10	48
Memo:					
All U.S. Brands	186	28	15%	98	53%
All Japanese Brands	59	7	12	32	54

*Excludes one test of 15 models in which all 15 were deemed about equal in overall quality.

Source: Consumer Reports (various issues)

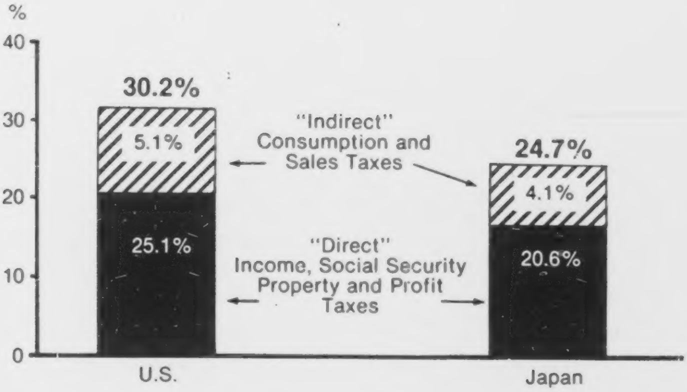
The results of comparative tests conducted by Consumers Union during the 1970's demonstrated that the American consumers' confidence in the quality of domestic television receivers was fully justified. The situation has been somewhat different in the U.S. automobile market, however.

Japanese automobiles today enjoy an earned and enviable reputation for excellence in finish, fit, and reliability. Cars built in the United States have a record of failing to meet consumer expectations in these very visible aspects of quality, although they have matched or exceeded imports in the less visible areas of durability and safety.

Reducing U.S. trade deficits will certainly require that management and labor achieve levels of product quality that meet international standards. It will also require, however, that the Government of the United States take effective action to prevent Japan and other nations from using the facade of local quality standards to impose design and testing requirements on fully competitive U.S.-produced products that are so onerous as to effectively preclude the sale of U.S. products in their home markets.

TAX REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT

1978-1980



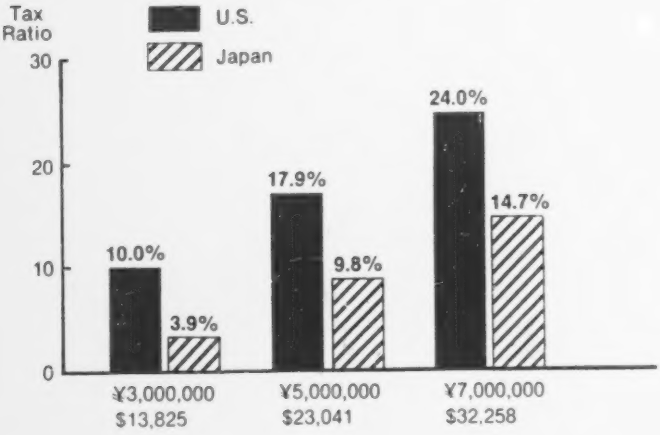
Source: Revenue Statistics of OECD Member Countries

In the United States, federal, state and local taxes exceed 30 percent of GNP. In Japan, such taxes amount to less than 25 percent of GNP. Japanese tax levels are lower primarily because defense expenditures total about 7 percent of GNP in the United States compared with less than 1 percent of GNP in Japan.

Income, social security, and profit taxes that are imbedded in the cost of a product when it goes to market and that are classified as "direct" taxes by international trade conventions amount to 25.1 percent of GNP in the U.S. and 20.6 percent of GNP in Japan.

U.S. AND JAPAN EARNINGS AND TAX RATIOS

(MARRIED PERSON WITH TWO CHILDREN)

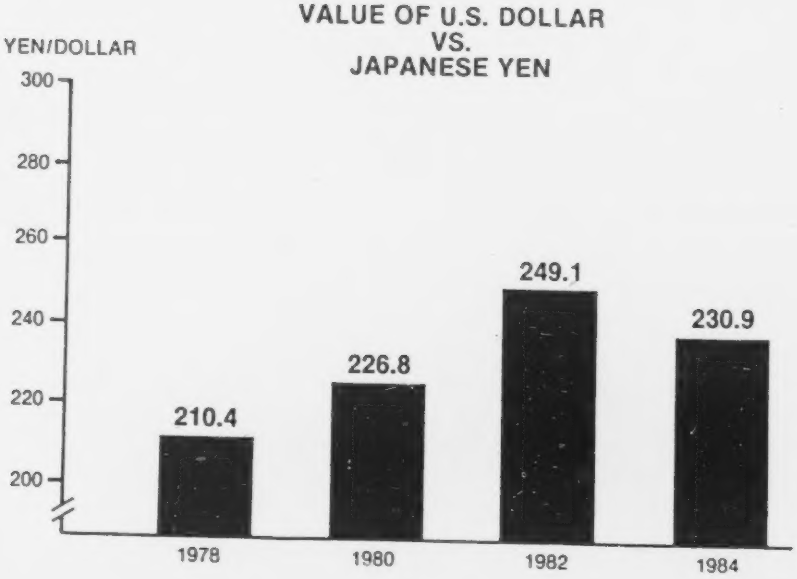


Source: Ministry of Finance, Japan

Many U.S. products suffer a labor cost disadvantage in international trade because U.S. wage rates are frequently higher than wages overseas. In industries such as the U.S. automobile industry, the labor cost disadvantage is compounded by the fact that U.S. automobile workers are paid wages that significantly exceed those prevalent elsewhere in U.S. industry.

U.S. management and labor must, of course, accept the responsibility for responding to labor cost problems associated with wage rates in a particular U.S. industry that are excessive relative to wages paid elsewhere in this country.

A significant portion of the U.S.-Japan wage rate difference, however, is attributable to the fact that wages and salaries in the U.S. are taxed at rates about twice those assessed in Japan. U.S. labor and the products it produces are today carrying a larger share of the costs of defending Japan's home islands and critical supply lanes than are Japanese labor and the products it produces. Labor in the U.S. must be paid more than Japanese labor if it is to have comparable after-tax earnings.

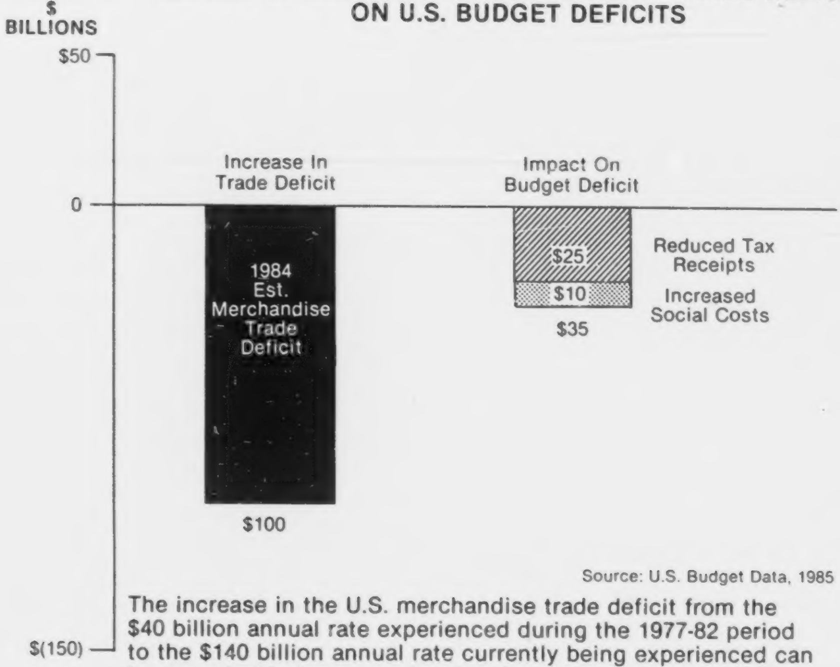


Source: Chemical Bank

The imbalance in the yen-dollar relationship has often been cited as a major cause of growing U.S. trade deficits. Some observers contend, however, that the imbalance is more attributable to adverse reactions to U.S. budget deficits than to actions the Government of Japan has taken to limit foreign access to Japanese money markets and control the use of the yen in world money markets. In fact, it is often asserted that if U.S. budget deficits were reduced, the yen-dollar imbalance would be alleviated and U.S. trade deficits would decline.

Such assertions, in my view, are seriously oversimplified. There is considerable evidence, in my opinion, to support the contention that losses in U.S. tax revenues and increases in domestic social costs attributable to the huge and growing U.S. trade deficits are adversely impacting U.S. budget deficits to at least as great an extent as U.S. budget deficits are adversely impacting U.S. trade deficits.

IMPACT OF INCREASED MERCHANDISE TRADE DEFICITS ON U.S. BUDGET DEFICITS



Source: U.S. Budget Data, 1985

The increase in the U.S. merchandise trade deficit from the $40 billion annual rate experienced during the 1977-82 period to the $140 billion annual rate currently being experienced can be expected to have a seriously adverse impact on the U.S. budget deficit.

A $100 billion increase in the merchandise trade deficit will result in a loss of approximately $25 billion in federal, state, and local revenues from income, social security, and other "direct" taxes.

A 1982 ITA study concludes that for each $1 billion of trade deficit 25,000 jobs are eliminated in the United States. Based on that estimate, a $100 billion increase in trade deficit will result in the loss of 2.5 million jobs and an increase in unemployment, welfare, and other social costs approximating $10 billion.

The reduction in tax revenues and increases in social costs resulting from a $100 billion increase in the U.S. merchandise trade deficit is likely to adversely impact U.S. budget deficits by about $35 billion annually, an amount that would more than offset all of the fiscal benefits the Congress has sought to accomplish through curtailments in non-defense spending.

U.S. AND JAPANESE SMALL CAR TAX RELATED COSTS IN THEIR HOME MARKET

($5,900 U.S. Factory Price)

	U.S. Built	Japanese Built
Manufacturer Related		
Income and Property Taxes	$ 440	$ 440
Commodity Tax	—	575
Subtotal	$ 440	$1,015
Employee Related	1,110	230
Total	$1,550	$1,245

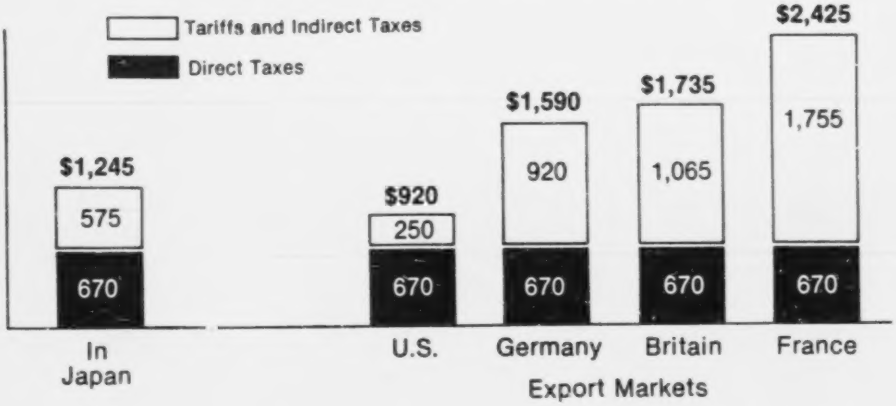
Source: "Doorstop for free trade"
Harvard Business Review
March-April 1983

Differences in total tax levels and in the manner in which taxes are assessed have a very substantial impact on the tax-related costs that must be recovered when automobiles produced in the U.S. and Japan are marketed.

A U.S.-built small car would carry with it to market about $1,550 of tax-related costs if it were sold in the U.S. Property and corporate income taxes paid by U.S. manufacturers account for about $440 of that tax burden. The remaining $1,110 is attributable to employee-related tax costs such as the social security and unemployment taxes that U.S. employers pay on behalf of their employees and the portion of their wages that automobile workers pay to federal, state and local governments in the form of income and social security taxes.

A comparable car would carry a tax load of only $1,245 if it were built and sold in Japan. Japanese manufacturers incur most of their tax costs in the form of taxes on profits and an excise tax (called the commodity tax) that they are required to collect at the time of sale in Japan.

TAXES AND TARIFFS ASSESSED ON SMALL JAPANESE CARS

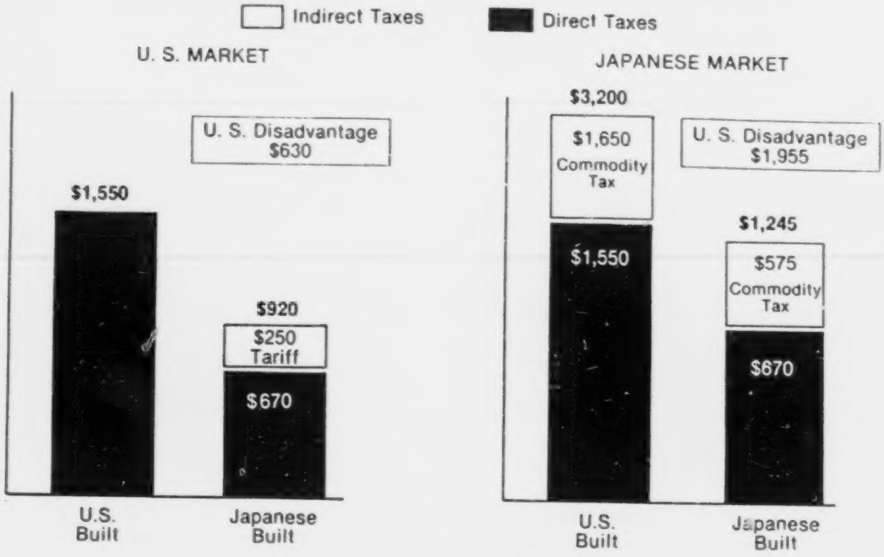


Source: "Doorstop for free trade"
Harvard Business Review
March-April 1983

International trade rules permit nations to rebate indirect taxes but not direct taxes at the time a product is exported and to assess indirect taxes but not direct taxes on products that are imported. As a result of these conventions, a Japanese-built car that would carry taxes totaling $1,245 if it were sold in Japan would incur a tax burden of only $920 if it were sold in the United States. The car would qualify for a $575 rebate of Japan's indirect commodity tax when it was exported and because the U.S. tax system relies on direct taxes, it would incur only about $250 in tariffs and duties when it entered the U.S.

If the same car were exported to Western Europe, it would incur a Common Market tariff and be assessed European value-added taxes which are classified as "indirect." In Europe, it would incur tax-related costs totaling $1,590 if it were sold in West Germany, $1,735 in Great Britain, and $2,425 in France. The United States is the only industrial nation that does not assess substantial taxes on imported automobiles.

U. S. AND JAPANESE SMALL CAR TAX-RELATED COSTS WHEN SOLD IN U. S. AND JAPAN



Source: "Doorstop for free trade" Harvard Business Review March-April 1983

A $5,900 small car produced and sold in the United States incurs tax-related costs totaling $1,550. In the U.S. market, the U.S.-built car is at a tax disadvantage totaling $630 per unit relative to a Japanese import that incurs Japanese and American tax-related costs totaling only $920. If the same U.S.-built small car were exported to Japan, it would incur tax-related costs totaling $3,200 and be at a disadvantage of $1,955 per unit relative to a small car produced and sold in Japan.

An automobile manufacturer cannot incur excessive material, labor or overhead costs and compete effectively with a more efficient producer that prices its product aggressively. Exactly the same condition exists with respect to tax-related costs.

As individuals, U.S. consumers may benefit from the tax advantages that imported cars enjoy; but as a group, U.S. consumers lose. U.S. federal, state and local governments collect taxes totaling some $1,550 when a U.S.-built small car is sold domestically. They collect only $250, or $1,300 less, on the sale of an imported car. If government services are to be maintained, the tax losses and the added unemployment and welfare costs associated with import sales will have to be recovered from other taxes and it is U.S. consumers as a group who will pay those other taxes.

CONCLUSIONS

In his book, **The Amazing Race,** Professor William Davidson of the University of Virginia notes that the United States is engaged in a "two-front war." In the military arena it must compete with a USSR that neglects its industry to focus on military supremacy and in the industrial arena it must compete with a Japan that neglects its military to focus on industrial supremacy. U.S. trade policy, however, has failed to recognize that reality.

The United States has incurred huge merchandise trade deficits during a period in which its labor force was the most productive in the world and its energy costs were the lowest in the industrialized world. It has incurred those deficits during a period in which it benefited from domestic raw material resources far greater than those of the other industrialized nations and in which its abundant agriculture made it far less dependent on imported food.

If there were free trade in the world, the U.S. would not be struggling today to control huge trade deficits. The world, however, does not have a free trade system; it has an administered trade system. Other nations have sought to minimize unemployment at home and earn the dollars needed to pay for imported oil by rigidly limiting imports and aggressively promoting exports. U.S. trade policy, on the other hand, has been governed by a "Marshall Plan" mentality that continues to view the U.S. economy as being so strong as to be immune from injury regardless of the inequities that the U.S. accepts in international trade.

The time has come for the United States to respond to **all** of the causes of huge and growing U.S. trade deficits which include the exclusion of U.S. products from foreign markets, an overvalued dollar, inequitable international trade tax conventions, and unfair trade practices such as dumping.

If effective action is not taken, public support in the United States for protectionist measures that could seriously damage the world trade system will continue to increase and the ability of the U.S. economy to support essential social and defense programs will continue to diminish.

Doorstop for free trade

John J. Nevin

Instead of restricting automobile imports through local content laws, the United States should address inequities in international tax conventions

The first pages of the business sections in our newspapers increasingly run stories about some industry leader asking the government to curb Japan's seemingly rapacious advance in U.S. markets. Some arguments focus on the unfairness of Japan's restrictions on imported U.S. goods compared with our open door policy. Other arguments emphasize the damage of one-way trade to our economy. The result is a growing demand to restrict imports through quotas, minimum price mechanisms, or local content regulations.

In this article a corporate CEO who has had experience in trade controversies between Japan and the United States notes that those controversies have often involved allegations of inequities in the international trade system or unfair trade practices. He worries that artificial restraints on imports curtail the many benefits of free trade but leave the rancorous issues of equity and fairness unresolved. He thinks we would be the poorer if we closed our markets to imported cars and suggests instead that a minimum tax on automobile imports would eliminate inequities caused by the 1947 GATT agreement and leave the door open for trade that is fair and free.

Mr. Nevin is chief executive officer and chairman of the board of Firestone Tire & Rubber Company. This is his second article in HBR. He wrote "Can U.S. Business Survive Our Japanese Trade Policy?" (September-October 1978) when he was embroiled, as CEO of Zenith, in an effort to alter government policy on the alleged dumping of Japanese television receivers in the United States.

Illustrations by Karen Watson

For some time now, public opinion polls have shown protectionist sentiment approaching landslide proportions in the United States. In the summer of 1978, a Harris survey found that Americans by a margin of 61% to 33% favored "more restrictions on foreign products coming into this country" over a continuation of the U.S. "tradition favoring freer trade." By a margin of 64% to 26%, those polled agreed with the statement, "We have been made suckers by other countries which restrict U.S. goods but whose goods are free to come into this country."

In mid-1980, another Harris survey determined that by a 70% to 26% margin the public favored "the United States passing a law that would make it mandatory that any mass-produced foreign car in the United States must be built in plants in this country employing American workers."

Now, Congress is expressing the frustration and disenchantment long evident in the attitudes of the U.S. public on international trade issues. In December 1982 the House of Representatives, by a vote of 215 to 188, passed a bill requiring up to 90% of the parts and labor used to produce automobiles sold in the United States to be "made in America." The legislated domestic content percentages would vary with the manufacturer's annual unit sales. To sustain current U.S. sales volumes, Nissan and Toyota would have to make sure that at least 70% of their parts and labor were domestic by 1986; major U.S. manufacturers would have to meet the 90% requirement.

Eventually the proposed legislation would effectively bar the sale of automobiles imported into the U.S. market in high volume. But it would offer little immediate relief to currently unemployed automobile workers. In congressional hearings, supporters acknowledged the bill's imperfections but defended their course of action by citing Japan's refusal to "play fair" in international trade. Allegations that other nations have not played fair have been important elements in all major trade controversies in which the United States has been involved during the past decade. Washington administrations, however, haven't supported investigations to test the validity of these allegations.

In early 1976, the International Trade Commission (ITC) began an investigation of "unfair acts" associated with Japanese television receiver imports. These included "a systematic effort to import or sell television receivers in the United States at prices substantially less than the actual market value or wholesale prices in Japan…with the intent of destroying or injuring an industry in the United States" and "a concerted scheme to fix and maintain artificial prices of electronic products in Japan." For almost a decade, U.S. manufacturers alleged the Japanese were able to dump television sets in the U.S. market at very low prices because they could offset losses or marginal profits on U.S. sales with high profits on sales in a home market closed to foreign competition.

The Ford Administration's Treasury Department frustrated this inquiry by refusing to allow ITC investigators to examine relevant Treasury files. In May 1977, the Carter Administration negotiated an Orderly Marketing Agreement with Japan that limited Japanese television exports to the United States. Three months later the ITC terminated its investigation. In July 1978, the administration disclosed that when it signed the Agreement, it had given the Japanese government a letter promising to "recommend" that the ITC terminate its investigation of television dumping.

For some time U.S. steel companies have alleged that European steel producers benefit unfairly from government subsidies designed to maintain employment in uneconomic mills by making it possible for those mills to export steel to the United States at prices well below production costs. The Ford and Carter Administrations elected to avoid or delay investigations to determine the merit of the allegations. They sought instead to calm domestic political protests with negotiated agreements limiting steel imports through minimum price mechanisms or quotas.

American manufacturers have not accused Japanese producers of dumping cars in the U.S. market, nor have they suggested that Japanese producers are subsidized by their government. They have asserted, however, that automobiles produced in the United States suffer from an unfair tax disadvantage when they compete with Japanese imports in the U.S. market. The controversy has been exacerbated by a widespread conviction in this country that the Japanese have effectively closed their home market to U.S. exports while demanding that the United States pursue a free trade policy with respect to Japanese cars.

Unemployment in U.S. automobile and related industries now totals one million people. Half of those who are without jobs would be working if cars currently being imported from Japan were built in U.S. plants. In 1978, the last of the "good" years, the combined profits of General Motors, Ford, and American Motors totaled $4.9 billion. Two years later, their losses totaled $4.2 billion. Of the U.S. automobile manufacturers, only General Motors is now paying a dividend to its shareholders.

The effects of the automobile crisis extend far beyond the losses that industry employees and shareholders have incurred. Because layoffs and plant closures in the automobile and related industries have reduced tax revenues to levels below those required to maintain government services, several states and scores of municipalities in the Midwest face fiscal crises. And at a time when the government is finding it difficult to finance both an adequate national defense and basic social programs, the curtailment of domestic automobile production has reduced federal tax revenues by billions of dollars. In 1982 the deficit incurred in automotive trade with Japan exceeded by about 50% the deficits the United States incurred in trade with OPEC.

The anger and impatience that characterize the current foreign trade debate could produce a legislative reaction that would severely damage an international trade system that is as important to the United States as it is to the rest of the world. The task of restoring confidence in the world trade system and in the government's international trade policies is urgent.

An effort to restore the confidence of the American people would probably not succeed if it relied on agreements or legislation restraining imports through quotas, minimum price mechanisms, or domestic content regulations. Such measures limit the options available to U.S. consumers and reduce the economic pressure on domestic producers to become more competitive. And they fail almost totally to respond to the rancorous belief that inequitable and unfair practices in world trade injure U.S. labor and industry.

In the short term, a successful effort to restore the confidence of the U.S. people in free trade would require a response to problems such as those in the automobile industry that is fair to U.S. consumers and workers and also defensible abroad as being reasonable. Over the longer term a solution will have to address effectively the widespread conviction identified in the 1978 Harris poll that the United States is the "sucker" in international trade. In both instances, trade relationships between the United States and Japan would become the focal point, for many believe that imports from Japan are a main cause of automobile industry unemployment. It is widely held that the Japanese market is far less open to U.S. exports than markets in Europe and other parts of the world.

In recent years, Japan has concentrated its financial and human resources on the development of a few very efficient industries that compete aggressively in worldwide export markets. Radio and television receivers and cameras were early products of that strategy. Automobiles are a current example; semiconductors and computers are likely candidates for the future. While the Japanese have demonstrated extraordinary levels of manufacturing efficiency, product innovation, and other elements of competitiveness in these industries, their economy includes scores of other industries that do not approach world standards in efficiency. If free trade existed between the United

States and Japan, U.S. imports could capture large shares of the markets in Japan served by these less competitive industries. (For examples of Japanese import barriers, see the ruled insert.)

Tax inequities in automobile trade

Tax-related costs account for a surprisingly large percentage of the total costs of manufacturing an automobile in the United States (see *Exhibit I*). A U.S.-built car with a $5,900 factory price in the United States carries with it to market some $1,550 in tax-related costs. Approximately $440 of this burden comes from property and corporate income taxes that U.S. manufacturers pay at federal, state, and local levels.

On a U.S.-built small car, employee-related tax costs total about $1,110 including the social security, unemployment, and related taxes that the employer pays on behalf of employees. This sum also covers the part of their wages that employees pay to federal, state, and local governments in the form of income or social security taxes. Tax costs account for about 30% of the wages paid in U.S. automobile plants compared with only 15% in Japan. About one-third of the differential in wages American and Japanese automobile workers receive covers the higher taxes paid by individuals in the United States.

A car that would carry $1,550 of home-market taxes if it were built and sold in the United States would carry a tax load of only $1,245 if it were built and sold in Japan. Japanese manufacturers pay most of their tax costs in the form of taxes on profits and an excise tax (called the commodity tax) that they are required to collect at the time of sale in Japan. In the United States, federal, state, and local taxes amount to almost 30% of GNP. In Japan, they amount to less than 25%. Tax levels in Japan are lower primarily because Japanese defense expenditures approximate 1% of GNP compared with about 6% in the United States.

But differences in defense-related tax costs account for only a portion of the tax disadvantage of U.S.-produced automobiles competing in the U.S. market with Japanese imports. The 1947 General Agreement on Tariffs and Trade (GATT) established a differentiation between the treatment of direct and indirect taxes in international trade. When GATT was adopted, however, none of the signatory nations relied on indirect taxes for a major portion of its tax revenues. The indirect taxes that were assessed were limited to sales taxes in the range of 1% to 3%.

But things have changed. The property, social security, income, and profit taxes that constitute by far the greatest portion of the taxes assessed in the United States are classified as direct taxes. On the other hand, the value-added tax used in Europe and Japan's commodity tax are considered indirect taxes. International trade rules permit nations to rebate indirect taxes on exported products and to levy indirect taxes on imported products. But direct taxes cannot be rebated on exports or assessed on imports.

Japan's commodity tax is limited to products such as automobiles, television receivers, stereo equipment, and some luxury items. The tax rate is 17.5% on small cars and 22.5% on larger cars. European value-added taxes are assessed on most goods and services at standard rates in the range of 12% to 16%, but rates much higher than the standard are often applied to automobiles. Japan's commodity tax and the European value-added taxes are indirect taxes that can be assessed on imports. The United States is the only major industrial nation that does not levy heavy taxes on imported automobiles.

A Japanese-built car with a home-market tax burden of $1,245 would incur taxes totaling only $920 if it were sold in the United States. The $575 commodity tax would be rebated when the Japanese car was exported, and because the tax system in the United States is based on direct taxes that cannot be levied on imports, a Japanese car would incur only about $250 in tariffs and other duties when sold in the United States. On the other hand, a similar sized U.S.-built car sold in Japan would incur a tax burden of $3,200. The U.S. manufacturer would obtain no tax rebate when such a car left the United States, and on importation into Japan it would incur $1,650 in taxes – because Japan's indirect commodity tax can be levied on imports.

The same Japanese-built car would currently incur taxes totaling $1,590 in West Germany, $1,735 in Great Britain, and $2,425 in France (see *Exhibit II*). Thus General Motors and Ford can compete successfully with Japanese producers and earn substantial profits when they manufacture and market cars in Europe and elsewhere. Part of the answer why they find it difficult to compete when they manufacture in the United States lies in inequitable international trade tax conventions that the U.S. government accepts meekly.

A U.S.-built car carrying $1,550 in tax-related costs in the home market is at a $630 disadvantage when it competes with a Japanese import carrying a combination of only $920 in Japanese and American taxes. Tax-related costs, like other costs, must ultimately be recovered in the marketplace if a company is to stay in business. As is well known, a manufacturer who is noncompetitive in material, labor, or overhead costs will be unable to recover excess costs if competitors price aggressively. It is the same with tax-related costs. How can U.S. automobile producers recover a $630 per unit tax disadvantage and compete successfully with aggressively priced automobile imports from Japan? Tax inequities place U.S. automobile workers and manufacturers at an unfair disadvantage.

As individuals, U.S. consumers may benefit from the tax advantages that imported cars enjoy; but as a group, U.S. consumers lose. U.S. federal, state, and local governments collect taxes totaling some $1,550 when a U.S.-built small car is sold domestically. They collect only $250, or $1,300 less, on the sale of an imported car. In addition, the costs of welfare and other social programs in the United States are increased by about $850 per unit each time an import is sold in place of a domestically produced car, and unemployment in U.S. plants is increased or extended. If government services are to be maintained, the tax losses and the added social costs associated with import sales will have to be recovered from other taxes, and it is U.S. consumers as a group who will pay these additional taxes.

Addressing the inequities

Congress could eliminate tax inequities in the U.S. automobile market by increasing the tariff on imported cars to 20% from the current 2.8%. With a 20% tariff, the United States would collect taxes on imports that would approximate those that the government of Japan collects by imposing its commodity tax at rates of 17.5% or 22.5%. A 20% U.S. tariff would constitute a far smaller tax burden on automobile imports than that which European countries impose through a combination of the Common Market tariff and subsequent indirect taxes levied by member states.

Increasing tariffs, however, might be ill-advised as this would send a negative signal around the world and violate tariff reduction agreements to which the United States is committed. A tariff increase on automotive imports would require a complex set of rules defining a "complete" automobile to prevent importers from avoiding the tariff by installing a few domestic components and claiming that the vehicle had been "made in America."

Tax inequities in the automobile trade could be more effectively eliminated if Congress enacted a 17.5% minimum excise tax on all automobiles sold in the United States. Such an excise tax could be structured to permit manufacturers to take credit against the excise tax liability for any income, social security, or other direct taxes that they or their

Japanese import barriers

In free trade practice, efficiently produced U.S. agricultural products should flow in great quantities to Japan. But they do not. In testimony before the Committee on Foreign Relations of the United States Senate, on September 14, 1982, Ambassador David R. Macdonald, Deputy United States Trade Representative, pointed out that "Japan maintains quotas on 22 agricultural and marine item categories which cover over 100 products." Quotas, however, constitute only a part of the wall that has been built to prevent U.S. agricultural products from entering Japan.

For instance, the Japanese consume cigarettes at a per capita rate that is roughly equal to the American consumption rate. Cigarette sales in Japan represent a $10 billion business. However, largely because U.S. cigarettes must be distributed by the Japan Tobacco and Salt Corporation, a government-approved monopoly, U.S. cigarettes have only slightly over 1% of the Japanese market.

Japan has roughly 250,000 stores and 270,000 machines where consumers can purchase cigarettes. But only 20,000 of those outlets can sell American tobacco products.[1] American cigarettes are subject to a 35% tariff in Japan and sell at prices set by the monopoly that are about 60% above the price of Japanese cigarettes. If U.S. marketers wish to promote their cigarettes with samples in Japan, they have to buy cigarettes for the promotion from a Japanese [illegible] at retail prices.

Even the victories Americans have claimed in their highly publicized efforts to open the Japanese market to agricultural products have been hollow. In 1979, Japan was importing 16,800 tons of prime and choice beef from the United States. After a long series of discussions, the Japanese agreed to accept 14,000 more tons annually by 1983. That "breakthrough" was put in perspective by Senator Lloyd Bentsen of Texas when he noted that the increment was the equivalent of one McDonald's "Quarter Pounder" for each Japanese citizen per year.

American manufactured products also face formidable Japanese trade barriers. Under existing procedures each automobile imported into Japan has to be driven to the local department of motor vehicles for an inspection that typically requires a three- or four-hour wait before aggressive, bespectacled inspectors finally descend upon the car. Imported cosmetic products missing even one single ingredient from the Japanese government's approved list must be held back for a safety test. It can take as long as two years to arrange such a test. While Japanese cosmetic manufacturers apparently have access to the top official list of 2,800 ingredients approved by the Japanese government, foreigners don't.[2]

There appears to be a growing awareness on both sides of the Pacific of the need to respond to the perception in the United States that Japanese markets are closed to our exports. In late December 1982 Japan announced reductions in tariffs on tobacco and other agricultural products, promised a continued effort to reduce nontariff barriers, and also agreed to permit American cigarettes to be sold in 70,000 retail outlets by April 1983.

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[1] Representative L.H. Fountain, North Carolina, in a November 4, 1982 Press Release.

[2] Bernard Krisher, "Japan Opens Some Doors to Imports," Fortune, January 25, 1982, p. 47.

Exhibit I [illegible]

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	[illegible]	[illegible]	[illegible]	[illegible]
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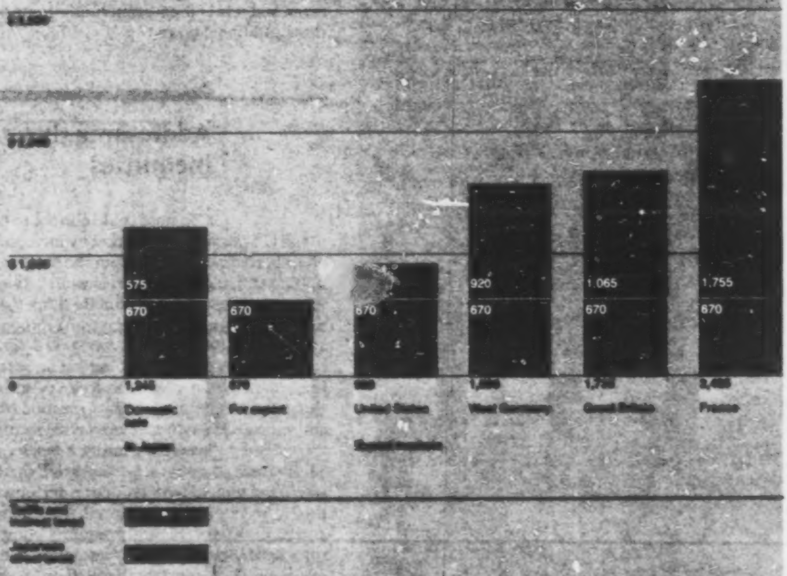
	[illegible]	[illegible]	[illegible]	[illegible]
	[illegible]	[illegible]	$ [illegible]	[illegible]

Exhibit II [illegible]



domestic suppliers paid themselves or remitted on behalf of their employees while manufacturing automobiles or automotive components in the United States. For domestic manufacturers who bear the burden of the U.S. direct tax structure, the available credits would equal or exceed the excise tax liability. Importers, of course, would incur an added tax that would eliminate much of their current cost advantage.

The enactment of a minimum 17.5% excise tax on all cars sold in the United States would be fair to U.S. automobile workers and consumers and would be defensible abroad because it would correspond to the tax policies of other industrialized nations. It should also provide more immediate relief for unemployed automobile workers than a domestic content law that would not take effect for several years. Moreover, a minimum 17.5% excise tax would have two big advantages for the U.S. economy, regardless of how importers responded to the new levy:

☐ If, as is probable, the tax led to a reduction in sales of imported cars, or induced foreign companies to manufacture their products or purchase components for them in the United States, any reduction in excise tax collections would be offset by increases in government revenues from direct taxes on property, profits, and wages.

☐ If importers chose to absorb part of their minimum excise tax liability in an effort to maintain their shares of the U.S. market, government revenues from the sale of imported cars would offset, at least partially, the loss of direct taxes associated with the displacement of domestic products.

Some will argue against the minimum tax proposal by asserting that the tax would violate or circumvent GATT conventions on the treatment of direct and indirect taxes. But the tax inequities American automobile manufacturers face today are the result primarily of tax laws enacted in Europe and Japan 15 or 20 years after the GATT conventions were signed. In light of the effect of these changes, it is not unreasonable for the United States to demand of its GATT trading partners the right to enact tax legislation to reduce or eliminate the tax inequities American producers confront.

Others may object on the grounds that the proposed minimum excise tax will be inflationary if Japanese manufacturers raise their prices in the United States to recover part or all of the new tax and U.S. manufacturers follow suit. Even if one were to accept the argument that such a tax could result in higher automobile prices, one would have to reject the premise that continued tolerance of tax inequities constitutes an acceptable basis on which to hold down car prices. Regardless of whether the minimum excise tax resulted in higher prices on autos, federal, state, and local governments in the United States would be the main beneficiaries of its enactment. They would collect either new excise taxes on car imports or higher direct taxes as employment and profits in the domestic automobile industry recovered.

Roles of industry & government

Inequitable tax treatment is by no means the only problem U.S. automobile manufacturers face when competing for sales with Japanese imports. U.S. consumers seeking fuel-efficient vehicles have for many years believed that imported cars were more responsive to their needs. In addition, automobiles produced in the United States suffer from a substantial labor cost disadvantage partly because it takes fewer hours to build cars in Japan's highly automated plants and partly because Japanese autoworkers are paid less than their counterparts in this country.[1] Finally, Japanese imports enjoy an enviable reputation for excellence in finish, fit, and reliability. Cars built in the United States have a record of failing to meet consumer expectations in these very visible aspects of quality, although they match or exceed imports in the less visible areas of durability and safety.

As long as the United States pursued an energy policy that kept gasoline prices in this country far below levels elsewhere in the industrialized world, the big car product lines domestic manufacturers offered competed only indirectly with imported small cars. In January of 1979, the second oil crisis produced a sudden shift in demand from big to small cars. The Japanese were able to respond quickly to a radically changed market by making available in the United States the wide range of cars they offered in Japan, where high gasoline prices had long made fuel economy a marketing necessity. Before U.S. manufacturers could respond to the new market realities and compete head to head with Japanese imports in a market no longer segmented by size, they needed billions of dollars of investment and several years' time to redesign their products.

At a time when other U.S. corporations were conserving cash or using their available financial resources to diversify through acquisition, U.S. automobile companies committed some $80 billion to the design and introduction of new product lines and to plant automation and modernization. The U.S. manufacturers believe that those investments will make it possible for them to compete successfully with Japa-

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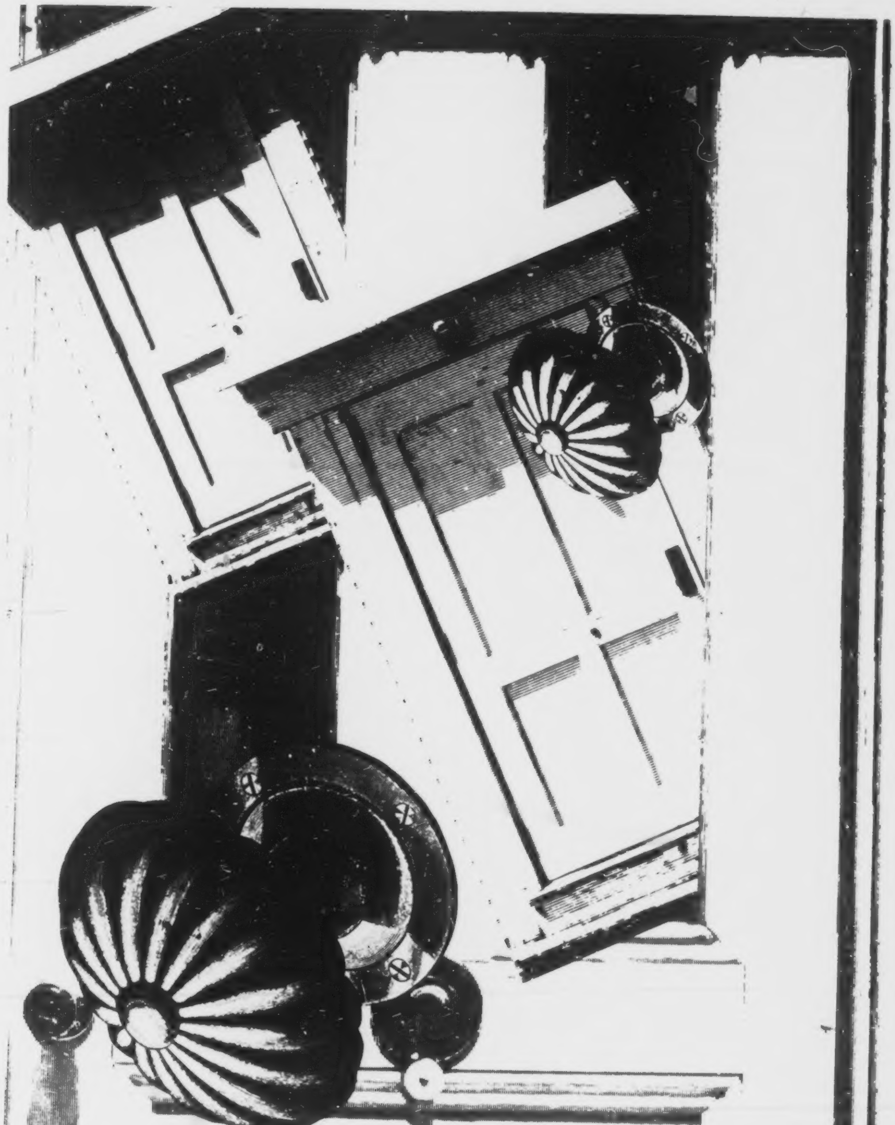
[1] For data on the landed cost advantage Japanese cars have, see "The New Industrial Competition," by William J. Abernathy, Kim B. Clark, and Alan M. Kantrow, HBR September-October 1981, p. 68.



nese imports. They have not supported local content legislation that would severely limit competition from abroad.

While the U.S. automobile industry itself can and should address the questions of fuel efficiency, labor cost, and quality image, the resolution of problems associated with tax inequities in the U.S. automobile market will require congressional consideration and action. A minimum excise tax will ensure that future competition between U.S. and Japanese automobile producers in the U.S. market is based on the appeal, manufacturing costs, and quality of their products and not on inequitable advantages or disadvantages that international tax conventions now cause and that local content laws would create.

In April of 1970 Zenith Radio Corporation submitted a petition to the U.S. Treasury contending that rebates of the Japanese commodity tax on television sets destined for the United States constituted an export subsidy that U.S. law required Treasury to offset by assessing a tariff in an equal amount. Treasury did not respond to the Zenith petition until January of 1976 when it was required to do so by the provisions of a trade law Congress had enacted a year earlier.

Until Treasury issued its "final determination" on the Zenith petition in 1976, Zenith had been precluded from taking its case to the courts. In March of 1978 the Supreme Court unanimously rejected a Zenith appeal of the Treasury ruling. In its decision, however, the Court made it clear that it was ruling on the narrow legal question of whether Treasury had the authority to pursue the course it had pursued. The Court stated that it was up to the Congress and not the courts to determine the fairness and economic effect of the disputed tax conventions.

The need for urgency

The time has come for Congress to consider these questions of fairness and economic effect.

The threat to the world trade system that U.S. protectionist sentiment now poses provides adequate grounds for assigning a high priority to the development of courses of action that would restore public confidence in free trade. There is, however, an additional reason for urgency.

Americans admire people who are candid, who are direct, and who "tell it like it is." The Japanese are more likely to admire people who are polite, who are tactful, and who are subtle. In times of harmony, those on either side can accept, and even admire, the characteristics of the other culture. In times of conflict, however, Americans acting in a manner consistent with their culture are often perceived by the Japanese to be arrogant and overbearing. In like circumstances, Americans might perceive the Japanese to be not forthcoming.

In the years following World War II, wise and sensitive leaders on both sides of the Pacific built a relationship between Japan and the United States that has been solidly grounded on feelings of respect and affection between the people of the two nations. That relationship is now seriously threatened by acrimonious disagreements over trade matters.

Many Americans strongly support a world trade system that is both free of restraints and equitable, and they are convinced that the United States can compete successfully under such circumstances. In the 1978 Harris survey, Americans were found to agree, by a margin of 74% to 23%, with the statement, "Many products from abroad are very good...and the American people should have a chance to buy them at reasonable prices." They also agreed, by a margin of 67% to 27%, with the statement, "With American know-how, we can compete with new products abroad."

Opinion surveys completed since 1978 have reported very similar attitudes. But they have also shown that if Americans are forced to choose between the status quo and protectionism, they will opt for protectionism as against an outdated "Marshall Plan" mentality that perceives Japan, as well as other nations, to be so weak as to justify our acceptance of inequities in foreign trade and U.S. industry so strong as to be immune from injury regardless of the magnitude of those inequities.

Time remains to develop and implement a course of action that will restore American confidence in the international trade system and also preserve and nurture the economic, political, and cultural relationships between American and Japanese people. There is still time, but not a great deal.

Senator DANFORTH. Mr. Nevin, thank you very much for your testimony. If you were king, if all the power of the Government were vested in you and you could do instantaneously whatever you wanted to change our system and our laws, what would you do?

Mr. NEVIN. Well, sir, I would stop trying to solve our—I may be overqualifying myself, but I'm going to respond to your question—I would stop trying to solve the problem in Tokyo and start giving consideration to how we solve it in Washington. I think that anyone who has been associated with the Japanese would assert that they have a democracy; that while it may differ in form from ours, certainly doesn't differ in substance. They are a democratic country. I think that there are two deeply rooted kinds of views among the Japanese people that we are not giving sufficient attention to. The first is a belief amongst even our senior business executives that their country has limited resources, that it's a nation that must struggle and protect itself against intrusions from the outside, and also, of course, it's a country that has a more recent but deeply committed position toward minimizing military resources.

I think we do our Japanese friends a disservice when we go to Tokyo and we yell at them about importing more American products. I think that if their senior Government officials were to come to the United States and tell us how we ought to run our country, we would not be very receptive to it. I think that this Nation tends to be based on the premise that if individuals pursue their self-interest within the limits of the law, the national interest will be served. I think there is more of an inclination in Japan to start with the consideration of the group interest.

And I will give you an example. Some years ago a Secretary of the Treasury said that if the Japanese didn't import more American beef or more American oranges, that we would let them sit on their Toyotas on the docks of Yokohama or some such thing.

And I would respectfully suggest to you, sir, that in the Japanese society that might be a preferable alternative. It is not a society that is inclined to permit its weakest industries to be decimated by trade. In the defense arena, their total defense budget amounts to less this year than the increase in our defense budget. And I think if you respect the Japanese democracy, they are unlikely to persuade the Japanese to significantly increase defense expenditures. I do not think it is unreasonable, however, for this country to say that if we cannot get anything, even baseball bats, into Japan that responding to the Japanese with restrictions on imports in this country becomes a matter of national interest. And particularly when you look at the kind of impact the trade deficit is having on our budget deficit and on the spiral of higher interest rates.

In the defense arena, I think you accept the fact that the Japanese are a democracy and they have a right to make a judgment of their own as to how much they will spend for defense. I don't see any reason why their products ought to come into the United States and compete with American products that are carrying an enormous defense related tax burden and be in a position to underprice us because they don't elect to carry a similar burden. At least we in the United States could make sure that their products carry the kind of tax burden that ours do, and at least we could protect

American labor which carries an enormously higher tax burden than Japanese labor from being priced out of the market in significant measure because the taxes it pays to support our Government so far exceeds the taxes that the Japanese worker pays.

Senator **Danforth**. You suggest changing our tax system?

Mr. **Nevin**. I would suggest that we either change our tax system, Senator, or that we enact legislation that would protect us in this country from the unanticipated impact of a tax system that has been adopted in international trade. At the time the GATT was adopted in the 1946–47 era, there were no sales taxes of any consequence anywhere in the world.

The United States had sales taxes in the 2 percent arena. And in the GATT agreement we set up protocols——

Senator **Bentsen**. We agreed at that time that it would not be considered a direct tax. But at that time we were trying to help the countries of Europe get back on their feet. And now it's quite a different situation. They are eating our lunch on some of these things. And you have got the same kind of a situation in Japan where they take the tax off as they send the product abroad. And in Europe you have got it where they add the tax on our things coming in; take it off on those things that are coming to us. And that gives them quite an advantage.

Mr. **Nevin**. Well, you are certainly right, sir. First of all, the economic conditions have changed, but the tax considerations have changed. The taxes that are so burdensome—the Japanese commodity tax and added value tax in Europe—I shouldn't say so "burdensome" but are so unfair to U.S. producers were all adopted in the late 1960's. They didn't exist in the 1940's. And to say that we agreed in the GATT to accept this kind of thing is to disregard the fact that the conditions that exist at the time we entered into that agreement differed totally from the conditions that exist today. And when you talk about taxes accounting for 25 percent of the cost of most products that are produced in the United States and sold in the United States, you are dealing with a cost load that is comparable to labor costs, comparable to overhead costs. And I would respectfully urge, yes, that we either—I'm not trying to duck your question, but I don't think it's for me to describe how I would change the American Tax Code. But I would either make the necessary——

Senator **Danforth**. We sure don't know.

Mr. **Nevin**. I would either make the necessary changes in the American Tax Code, or I would enact legislation that protected the United States—American labor and American industry—from unanticipated results of tax conventions that were adopted some 40 years ago. One way or the other.

Senator **Danforth**. I'd also say that you might be the only one in this room, Mr. Nevin, who hasn't expressed views on how we should change the Tax Code. [Laughter.]

Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman. Of course, I think one of the big problems we have now is what is created by these deficits that neither this administration nor the Congress has faced up to. And I don't believe for a minute that these deficits don't create high interest rates. I think they do. And the attraction of foreign capital here has helped keep them lower than they would have been otherwise.

But anytime you get in competition trying to sell in foreign market places, and you say you have 100 yard dash to it, and you get this kind of differential in currency rates—from 20 to 30 percent with the yen or with the mark—it's like giving your competition a 20 or 30 yard head start to that objective. And that's why I think that we are really not going to totally solve this thing until we make some serious headway on this deficit and get these interest rates down.

The prime rate today in this country is twice what it is in Japan.

Mr. **Nevin**. Yes, sir.

Senator **Bentsen**. Twice what it is in Germany. And that's what our manufacturers are having to do in cost of capital. And that finally goes into their product.

Mr. **Nevin**. And this is a vicious circle because the increase in the trade deficit from $40 billion to $140 billion reduces tax revenues and increases social costs. I estimate in my paper it's by $35 billion. That certainly is something that could be studied by one of the agencies available to the Congress.

What you have got is a vicious circle. You have got a Government deficit, and as the trade deficit grows, you have less and less tax generation in those industries that are being adversely impacted by the trade deficit. And then it offsets the efforts of the Congress to reduce the budget deficit, and you are in a giant circle. And I guess I'm saying that I would strongly disagree with those that have testified before this committee who suggest that the trade deficit is not a problem of any consequence for the average American.

Senator **Bentsen**. Well, it's a great export of jobs, and it's going to continue to drain jobs from us. And it's going to continue to cut our competitiveness unless we face up to that problem.

Mr. **Nevin**. Yes, sir.

Senator **Danforth**. Mr. Nevin, thank you very much for your testimony. It was very helpful.

Mr. **Nevin**. Thank you.

Senator **Danforth**. The next witness is Mr. Richard Heckert, vice chairman and chief operating officer, Du Pont.

STATEMENT OF RICHARD E. HECKERT, VICE CHAIRMAN AND CHIEF OPERATING OFFICER, E.I. du PONT de NEMOURS, WILMINGTON, DE

Senator **Danforth**. Mr. Heckert, thank you very much for being with us.

Mr. **Heckert**. It's a pleasure. Thank you for the opportunity.

Mr. Chairman, and members of the Senate Finance Committee, I am Richard E. Heckert, vice chairman of the Du Pont Co. I'm submitting a separate statement in which I detail my views on the trade deficit problem. This morning I would like to summarize my five main points.

No. 1, the single most important issue facing the Nation in the area of trade is the strong dollar. We estimate that the dollar is currently overvalued by about 30 percent. This, in effect, imposes a

30 percent tax on American goods sold abroad and grants a 30 percent subsidy to foreign goods sold here. If this situation continues, the long-term outlook for U.S. industry and employment is not good. Even agriculture will face serious hurdles.

No. 2, the strength of the dollar is linked to the high rates of real interest in the United States. High interest rates also discourage manufacturers from building and modernizing plants in this country. The high interest rates result from a combination of Federal budget deficits, inflationary expectations and restrictive monetary policies. Without real action directed at bringing down deficits and without some loosening of our monetary controls, high interest rates are likely to be around for some time to come.

No. 3, our present tax system works against our trade competitiveness. We should revise our Tax Code by lowering taxes on income and levying taxes on consumption. Consumption levies in the form of value added taxes are used by many countries to excuse social costs on their exports. So while our exports carry with them the cost of Government, goods from other countries arrive on our shores without at least some of this burden.

No. 4, we need to play hardball when it comes to trade policies. We insist on playing by the rules when many of our trading partners have pine tar way up the bat and shoe polish all over the ball. I'm certainly not suggesting that we get rid of the rules. I'm saying enforce them. For many years we have treated our trade interests with benign neglect, and now we express shock that we are getting clobbered.

While many in this country continue to call for free trade, our own industries face a host of nontariff barriers, including State-owned and State-subsidized competitors, when we attempt to market our goods abroad. The concept of free or fair trade might not be the right yardstick for evaluating trade relationships. There is a real question in my mind as to how much free and fair trade exists. They are probably misnomers and probably not helpful.

Trade has to be beneficial to both partners in order to succeed. We have lots of beneficial trade; we need more.

We are in particular trouble with our core industries—those industries that are vital to our economic health, our national security and domestic employment. Protection, at least on a temporary basis, will probably be necessary to preserve some of these industries. But even here we have to be tough. There should be no protection without a quid pro quo. Everyone involved in the protected industry, including management, labor, bankers and suppliers, will have to give a little. And in some cases, quite a bit.

The goal of protectionism should always be to make the protected industry strong enough to stand on its own two feet. If the industry can't make it against international competitors, playing by the same rules, then perhaps it's time to cut our losses and get out. The only exception should be industries that clearly fulfill a national need.

No. 5, we have got to get to work on points 1 through 4. The sad thing about our trade situation is that basically we know what is necessary to improve it, and yet we sit on our hands. Some people call it a failure of nerve. Others say that we can't expect much action in an election year. Perhaps that is true. Whatever the case, things are not going to improve by themselves. Action on any one of the points that I have mentioned would be a step in the right direction. Continued inaction will almost guarantee deepening trade deficits, and more industries and jobs lost.

The Commerce Department's statistics paint an alarming picture of this Nation's ability to compete in world trade. Business is the front line of those statistics. We see the situation becoming grimmer at a time when we should be claiming new ground. Unquestionably, business made its share of mistakes. So has labor and so has Government. But I can assure you that business is prepared to work hard at this problem and stands a good chance of succeeding if the policy issues I have mentioned can be resolved.

Business is not looking for a handout. I continue to believe, along with most of my colleagues in the business community, that the best help by far is self-help. If industry does all it can in terms of innovation, controlling costs and productivity improvement, the need for Government to take a direct, active role in the situation will be considerably lessened.

To summarize my points, the U.S. trade deficit, bad as it is, will continue to worsen unless action is taken to restore the dollar to realistic trading rates and to bring down real interest rates in the United States. At the same time, we need to revise the Tax Code so that taxes do not increase the price of U.S. goods to foreign buyers. We need to get tough on trade rules, primarily by insisting that reasonable access to foreign markets will be a precondition for continued access to our own.

Finally, we need to act on these issues and act quickly. My own company has a big stake in trade as does the Nation. We want to see U.S. trade succeed and prosper. And we will continue to contribute our best efforts toward that end.

My time is up, Mr. Chairman, and I will be happy to deal with the committee's questions.

Senator DANFORTH. Mr. Heckert, thank you very much.

[The prepared statement of Mr. Heckert follows:]

STATEMENT OF RICHARD E. HECKERT, VICE CHAIRMAN, E. I. DU PONT DE NEMOURS & CO.

Policies to reverse the United States trade deficit are long overdue. Formulation of such deficit reducing policies must be given the highest priority. We cannot postpone action. The cost in U.S. jobs and competitiveness is now unacceptable and is increasing.

The Du Pont Company has a major stake in U.S. exports. In 1983, Du Pont was the nation's fifth largest exporter with exports valued at $2.3 billion. We are deeply committed as well to the international trading system. Last year, one-third of our revenues came from exports and international operations.

There is little point in belaboring the statistics. In 1984, the trade deficit is expected to be well over $100 billion. The deficit has increased in each of the past five years and has roughly doubled in each of the past two years. The growing displacement of American goods by foreign goods limits our economic recovery and threatens our standard of living.

Our recommendations regarding the trade deficit will require a substantial change in government policy. We do not underestimate the challenge nor this nation's ability to meet it. The erosion of our industrial base which a continuing trade deficit of present magnitude threatens demands prompt and effective action.

1. The Exchange Value of the Dollar Must Be Reduced

The single most damaging factor to the United States trade balance is the extremely strong dollar. In effect, the phenomenal appreciation of the dollar since 1980 parallels price increases in U.S. produced goods and services in global markets, including our own domestic market. The distinguishing factor, however, is that these price increases are completely outside the control of U.S. business management. We are forcing U.S. producers to compete in global trade markets at prices effectively established in the New York financial markets. Indeed, it is as if a "currency tax" were imposed on U.S. goods and services sold abroad, while foreign-source goods and services are granted a comparable subsidy coming into our domestic market.

To illustrate the magnitude of distortion in the dollar's exchange value, the composite dollar value (as measured by Morgan Guaranty's trade-weighted index) has appreciated by about 40% from mid-1980 to mid-1984. On the same basis, the dollar is now about 11% stronger than it was in mid-1971, before its devaluation in connection with the breakdown of the Bretton Woods international financial structure. Actually, this composite value of the dollar greatly understates the disparity that now prevails vis-a-vis the currencies of some key competitor countries.* As a result of exchange rate changes, the average local currency prices of U.S. produced goods in the four key European countries are now 86% above their levels of four years ago, ranging from an increase of 62% in terms of German marks to an increase of 114% in terms of French francs.

Foreign Currency Cost of a U.S. Dollar

	Percent Increase Since 1980
Canadian dollar	15%
Japanese yen	20
Europe(4)-Composite	86
German mark	62
British pound	85
Italian lira	108
French franc	114

The effect of this phenomenal distortion in the dollar's exchange value has been a dramatic and continuing deterioration in U.S. trade performance. From a deficit of $25 billion in 1980, the U.S. merchandise trade deficit has progressively widened to $43 billion in 1982, $69 billion in 1983, and an estimated $120 billion for 1984.

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* The composite is heavily weighted--nearly 40%--by Canada, whose currency has moved much more narrowly vs. the U.S. dollar.

After growing at an average annual rate of 8.5% during the decade of the 1970's, U.S. exports in volume terms have declined at an average annual rate of over 4% so far during the 1980's. The rate of growth in U.S. imports shows the reverse pattern, accelerating during the 1980's.

In our trade with Europe, a U.S. surplus of over $21 billion in 1980 will have disappeared, with a billion dollar deficit expected this year.

These numbers are not simply economic statistics of academic interest; in the real world they translate into a growing loss of trade-impacted jobs in the U.S., and the erosion of our industrial base. To the extent that the strong demand associated with the economic recovery in the U.S. is satisfied by a disproportionate share of goods produced abroad, the beneficial ripple effects and investment spending impetus are lost to the U.S. economy.

The pattern of deterioration being experienced in the U.S. trade accounts portends increasing difficulty and serious consequences for both U.S. business and U.S. labor. This country can no longer afford to ignore the problem in the hope that it will somehow, someday correct itself. The price we pay in the interim will be too high; the damage to our economy will be irreversible.

2. High U.S. Interest Rates Must Be Lowered

One major cause of the strong dollar is the extraordinary level of real interest rates in the United States. Aside from the damage to our trade position through its effect on the exchange value of the dollar, the high interest rate level generates a whole litany of other economic problems which directly or indirectly affect our trade markets or our ability to compete effectively in them.

A most conspicuous example of this is seen in the debt-burdened developing countries. High interest rates drain the resources of these countries for debt service payments, forcing retrenchment of their domestic economic activity with more than proportionate shrinkage in their demand for import goods. With over $800 billion of LDC debt outstanding, each one percent increase in interest rates drains an additional $8 billion from these countries' already limited resources. U.S. exports to the big three Latin American countries, for example, declined by more than 40% from 1981 to 1983, primarily reflecting the effects of Latin American austerity measures taken in connection with their efforts to work out their debt problems.

The debtor developing countries have not been the sole victims of high U.S. interest rates. Many industrial countries, in their efforts to control the damage associated with their depreciating currencies, have been forced to raise their interest rates to levels above those preferred for domestic policy reasons. Rising interest rates in any country tend to hold down rates of economic growth, with commensurate shrinkage in their demand for import goods.

Domestic investment in the U.S. can also be dampened by an excessive cost of capital. And that investment is urgently needed for modernizing plants, increasing productivity, and improving our competitive position in global markets.

Interest rates are also a cost to business, and rising costs necessarily generate upward pressures on prices. The huge economically disruptive federal budget deficits include the effects of high and rising interest costs on our trillion-and-a-half dollar national debt.

To deal with the strong dollar and its destructive effect on our trade balance, we must look first at our extraordinarily high real interest rates. If we can successfully pursue policies to reduce interest rates, we will simultaneously alleviate numerous other impediments to more favorable trade results.

How, then, can we do something to get interest rates down? The answer is twofold, and pretty clear: we need more responsible fiscal management, coupled with a more realistic and compatible monetary policy. Recognizing what needs to be done, however, is obviously a lot easier than the doing will be.

More responsible fiscal management means a determined effort to reduce the federal budget deficit, and this should be accomplished largely through controlling of expenditures rather than through increases in taxes. The Grace Commission Report offers some fertile ideas on where to start.

On the monetary policy side, we must first acknowledge that finding the optimum rate of growth in money supply is no simple task. It requires a delicate balance between accommodation of economic growth and prevention of resurgent inflation. Seeking this balance is vastly complicated by the history of the Fed's policies and the related market expectations in the current environment.

Nonetheless, with our inflation rate having been brought down from 13.5% in 1980 to 3.2% in 1983, we are inclined to believe that Fed policy today is unnecessarily restrictive, holding interest rates high and threatening to abort the cyclical recovery currently under way. It seems that in its recent policy direction the Fed has become the victim of its own fears and has sought to limit economic growth in fear of possible inflationary pressures. A look at recent trends in underlying forces affecting price developments (e.g., oil prices and unit labor costs) suggests that the Fed's current fears are unwarranted, and the Fed in its restrictive policy leaning is unnecessarily thwarting the normal continuation of the current recovery.

3. The Tax System Should Favor Exports

Our present tax system works against our trade competitiveness. The United States relies heavily for revenue on taxes on income. In contrast, our trading partners emphasize taxes on consumption, such as the value added tax. By imposing value added taxes only on goods consumed in their countries, our trading partners lighten the tax burden on their exports. Concurrently, U.S. goods entering such countries bear a double burden; American firms are taxed on their earnings on overseas sales plus the U.S. export generally carries the value added tax burden when sold in the foreign market.

U.S. emphasis on income taxes is illustrated in the following table:

Percentage of Tax Revenues Derived from Selected Sources (1980)

Country	Taxes on Incomes and Profits	Consumption Taxes on Goods and Services
France	17.96%	29.15%
Germany	35.43	25.78
Italy	33.03	26.16
Japan	41.50	14.15
United Kingdom	37.71	27.20
United States	46.93	14.42

Source: Organization for Economic Cooperation and Development

While our exports carry with them the cost of our government, foreign goods arrive on our shores without a corresponding burden. Our primary objective should be to keep our own government's costs under control but, even if such efforts are not entirely adequate, we should make sure that the costs of government are distributed in a way that does not unreasonably burden U.S. goods in international markets. The United States should seriously consider revising our tax structure to replace some income taxes with a tax on consumption.

4. U.S. Trade Policy Must Support our Economic Interests

Having put into place sound fiscal and monetary policies and adjusted the priorities of our tax system, we will have positioned this country to compete aggressively in international trade. Yet we recognize that the trade problems we face are not wholly of our own making. We must take steps to make certain that the international trading system is not manipulated by some countries to the disadvantage of U.S. producers. Finally, we must develop balanced programs to protect temporarily those vital industries which are threatened with material injury by imports.

The trading world has come a long way since the post-World War II days that gave birth to the General Agreement on Tariffs and Trade. From an era in which the United States held all the economic cards and when almost all countries were market economies we have reached a time when other nations have become major traders and our own country seems to be alone in its confidence in the marketplace to allocate resources. U.S. policymakers have not, however, fully understood the significance of this evolution. For years, the United States has tolerated trade distorting practices of other countries while professing the ideal of free trade at home. While we would not advocate specifically matching the trade restrictions of other countries, we can no longer afford to keep our markets significantly more open than those of our more important trading partners.

The trading system has, by and large, served us well. But to remain viable, it must provide effective remedies against trade distortions caused by practices unknown to the signers of the GATT. Specifically, there must be an appropriate response to the trade impacts of government subsidies, state-owned or state-subsidized competitors and practices such as industrial targeting.

United States trade policies must provide recognizable benefits to Americans. If the elimination of trade barriers accomplishes nothing more than averaging down our standard of living to that of the rest of the world, there is no point to the exercise. In any case, if the liberal trading system is to play its role in improving global living standards, we have a responsibility to insist that the sacrifices asked of Americans bear some reasonable relationship to those of the citizens of our major trading partners. To remain viable, the trading system must be beneficial to all participants.

Here in the United States, we should be a bit less ready to allow free trade ideology to dictate our overall economic policy. We do not suggest watering down our commitment to the GATT and our international trade obligations. What we do suggest is that the overall economic costs and benefits of specific programs be weighed before adopting, automatically, the free trade response. There will be times, we submit, when modest and speculative consumer benefits may well be overcome by real costs to the economy of dislocated industries.

In an imperfect world there will still be times when we have to look out for our national interest. Protection, at least on a temporary basis, will continue to be essential for some industries and we should not hesitate to take this step when necessary. Generally, I think the protection card should be played as a last resort. When we do provide such protection, however, taxpayers and consumers who bear the related costs have every right to expect a quid pro quo. This means that companies must do what is necessary to become as efficient, productive, and competitive as possible. Management, labor, shareholders, and even bankers and suppliers must expect to see their compensation and rates of return cut while the threatened industry retrenches. The goal must be for industry to make itself fully competitive in the international marketplace without the permanent crutch of protectionism.

In the long run, the best help for industry is self-help. If industry does all that it can, the need for a more active role by government will be reduced.

5. Action on our Trade Deficit Cannot Wait

Without positive action the trade deficit worsens, our industrial base erodes, jobs are lost and our entire economy pays the price. Enough has been said about the measures required to reverse the trends; the time for action is now. Congress and the Administration jointly bear the responsibility for providing the needed policy leadership.

As we continue to recover from the recent recession, U.S. firms should be poised to recapture international markets. The trade statistics bear witness to the obstacles we face. In recent years, U.S. goods have lost much of their competitive edge in world markets. In some cases, business bears much of the blame; in others labor or government have made mistakes. This is not the time to look back. I can assure you that the business community is prepared to work hard on restoring the competitiveness of U.S. products. We stand an excellent chance of succeeding if the important policy issues that we have discussed are resolved.

Senator DANFORTH. You have pointed out the problem of the dollar, which you believe is related to the deficit. Is this correct?

Mr. HECKERT. I do.

Senator DANFORTH. And the problem of different tax systems between the United States and its different trading partners, and the fact that we play by different rules. At least we play by rules that other countries seem so often not to. If these three areas were redressed, if somehow we could get the deficit down and the value of the dollar relative to the yen in particular were changed, and if our tax system became one that encouraged Americans to do business abroad, consumption type tax, if we had a stronger system of enforcing trade rules and insisting on reciprocity with other countries, if we were to do all these, if Government could act just by snapping our fingers—of course, we never do that around here—but if we could, would American business be competitive? That is to say, I guess some would say, well, we don't try hard enough; we really are not hustling for world markets as, say, the Japanese are; that we don't make competitive products; that our people are overpaid and our products aren't as good as other countries.

Do you think that if Government were to do its best and somehow miraculously put in place the kind of recommendations that you have made, we would have a change or would that just be clearing out one of the excuses for our failure to compete?

Mr. HECKERT. Mr. Chairman, I think the change would be dramatic. I think without question many, if not most, of our difficulties in most industries would go away. I do want to add a little to your comment about the strong dollar.

Obviously, that is a complicated issue, and maybe it's not appropriate here to waste our time on defining precise cause and effect relationships. The strong dollar results from several different considerations. High interest rates is certainly one of the most important. But the other fact that we can't ignore is the perception that the exchange rate is set by trade. That the exchange rate is determined by the trading value of products and services is simply not true. The exchange rate is dominated by the flow of capital, and today that's making the dollar very much stronger and killing us in the trade area. So that's a complicated issue and it needs to be dealt with very thoughtfully.

But if the dollar could be restored to the relationship that we enjoyed with other countries in the late seventies and early eighties, we would be very much better off.

My second point would be that American industry really is competitive for the most part. The word productivity is misused at least as often as it is appropriately or correctly used. People substitute productivity for rates of increase in productivity and we all recognize the problem there. Our productivity is excellent in this country. Our rate of increase is not as high as in some of the other countries that have the advantage of seeing how it is done and copying us. And, quite frankly, in some of our industries, we do have problems that need correction.

But if we could deal with the strong dollar and with high interest rates, and revise the tax structure in the ways that I have suggested—I did have the temerity to make some specific suggestions—and if we can really get a level playing field established, we will have most of our problems solved. What's left over?

Well, some difficult ones. And I would be the last to suggest that we will ever solve trade problems completely by providing a good environment for industry. There are going to be a few left over that have to be dealt with with special concessions in the national interest. They may be employment considerations. They may be defense considerations. It's not a tidy area. You simply can't devise a system that works automatically and painlessly for all concerned. So that after we have done everything we can and solved most of the problems, we will still have to deal with certain problems in certain distressed industries. And we should not be ashamed to take those steps that are in the national interest. Sorry about the long answer.

Senator DANFORTH. Thank you, sir.

Senator Bentsen?

Senator BENTSEN. Well, that hard dollar is in part the result of the great inflow of capital. We had a net inflow last year of some $30 billion. We have a financial market here that is not only broad, but also deep. But we are one of the countries that has no real controls on the flow of capital. And that is good. But that also means that money can move out just as quickly as it came in. If you have that happen to you, then what happens in this country, without a question, is a major escalation of interest rates. And then I think you get into serious recession.

Now the reason for that money coming in is not just the high interest rates, but political and economic stability in this country. If foreign lenders ever get convinced that we are not facing up to the problems of the deficit, that we are not going to do something about it and turn that around, you will see that money begin to move out. And that's why it's important, I think, to move.

You have got another problem, it seems to me, with indirect foreign subsidies, particularly in the petrochemical business. You get into the situation where in the Middle East they will sell their product abroad for $24, $26 a barrel, whatever that price might be, but they will sell it to their State-owned industry for something far less than that.

Mr. **Heckert**. Or nothing.

Senator **Bentsen**. In effect, that means they are dumping it. And then they send the petrochemicals here and sell them to compete against us. And so you have a heavily subsidized state product coming here. And I don't care how productive you get, I don't know how you beat that kind of a situation without taking some counter action through the ITC or other method. You sure have to speed up that process or the ballgame is over before you do anything.

Mr. **Heckert**. Senator, you have stated it very well. I would like to go back to your first point, if I might, sir. I think it is extremely important that we take early action on some of these problems that we are discussing so that we can avoid a hard landing. I agree with you that the big danger in letting this go on too long is that the process will reverse finally, and then we will have real agony. We need to feather these things as quickly as we can, and get the dollar back where it belongs, and interest rates moving downward and hope that we can go through the transition without a crash.

The second point you made so eloquently for me is that if you find the answer to that, I hope the industry won't be the last to know it because we have a problem. [Laughter.]

Senator **Bentsen**. No further questions.

Senator Long.

Senator **Long**. This is an enormous problem, but American interest was so fragmented, so confused, so conflicting—I know in my own State they have decided there is an advantage to produce energy. But you get some fellow who is afraid to expedite it down there at New Orleans and he gets himself appointed chairman of a subcommittee on trade at the chamber of commerce, and gets some other fellows on there who is the same type as he, here these guys are resoluting for the chamber of commerce that what we ought to do is contrary to the overwhelming economic interest of the State. And that same type thing works throughout industry. You have got all kinds of people on both sides of all issues.

You mentioned a value added tax. I indicated that some years ago and still think it's a good idea. And I think 6 years ago I was being the first one there, and another, speaking for organized labor, coming in here to ask us for a value added tax.

So with all the conflicting points of view—they who won't invest money abroad, those who have investments abroad, those who want to trade with those people over there, and those who are making a profit out of our deficit—and it's very difficult to get Americans united or even to give an appearance of being united. Saudi Arabia is the lead horse, you might say, in this international oil cartel, which is clearly contrary to the General Agreement on Tariff and Trade and the concept of free trade and all the rest of that.

And they are using that energy to subsidize chemical and refining industries. They are going to seek to put the final product in here rather than just the energy. And if you try to do something about that, first, you get the international companies who have been required by that government to participate in that—now that government doesn't have all the conflicts. One man can speak for that government. He doesn't have to consult a legislature. And then when we try to do something about it on this end, our own companies come in here lobbying against that because they have been required to invest that money over there, they couldn't take it out, they were required to invest it there, so they come in here lobbying against what we might want to do in regard to our industries here.

And to unite, we need Presidential leadership. And then at that point, it reaches a summit stage. The King of Saudi Arabia talks to the President of the United States, and says, look, if you want our help over here to solve all these international problems or to have that energy available to western Europe, you must cooperate. The cooperation has to be a two-way street. So then the whole thing comes to a halt right there at the White House.

How are we going to get our people sufficiently united that we can solve most of this problem, even a major part of it?

Mr. HECKERT. You certainly describe the condition very accurately. And I'm well aware of that fuzzy line between the State Department and the Commerce Department. There is a lot of intermingling of issues to our disadvantage in the trade area.

I think the simple fact is that we are all of these things. I have to remind my friends who keep talking about consumers as if they were separate people. We are all producers, and we are all consumers, and we are all investors, and we are all everything whether we really believe that or not. If you analyze the stake that an ordinary person in this country has in each of those areas, it's very substantial.

So what we are dealing with are tradeoffs. In one way or another, if this democracy is to work, we have got to find mechanisms to communicate better between industry and government, and agricultural interests and all the rest, and recognize that there is no path that solves everybody's problem. That it will involve tradeoffs. Even within my own company we deal with this issue that you brought up, the subsidized feedstocks for foreign petrochemical industry. One department says, gee, I like to buy cheap whatever. And the other department says, you dummies, we sell it and make it.

Even within a single corporation or industry there are a great number of tradeoffs. That doesn't excuse us from the job of getting together, sharing the best information we have, and making the hard calls. Now all I can say is we are ready to help every way we can.

Senator LONG. My thought is if you had an army of 1,000 men, but they are fighting among themselves, some little fellow could just beat the socks off of you with 150 because he had a united army that was working together without any conflict within the ranks.

Mr. HECKERT. Part of our problem.

Senator LONG. Thank you.

Senator DANFORTH. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Heckert, unfortunately, I wasn't here to hear all your testimony, but I read it over. But I particularly commend everybody—in your testimony on the bottom of page 2 where you talk about the protection on a temporary basis may be necessary to preserve some industries, but even here we have to be tough:

> There should be no protection without a quid pro quo. Everyone involved in the protected industry, including management, labor, bankers, suppliers, will have to give a little. In some cases, give a lot.

And unfortunately that is not happening in our country at this time.

We went into these ridiculous quota systems for the automobile industry to protect them, and we got nothing out of it from the automobile industry. Do you agree with that? [Laughter.]

Senator CHAFEE. I know you are in a different industry.

Mr. HECKERT. Let me put it this way—I had better not publicly—they are a very large customer of ours. [Laughter.]

Senator CHAFEE. All right.

Mr. HECKERT. I'm not ducking that totally. You will recognize that each industry properly should speak for themselves. But I think there are a couple of dimensions here that we ought to be willing to reach out and touch on other people's business with respect to that.

First of all, I think the automotive industry has done some things.

Senator CHAFEE. Name me one that they have done to do something in connection with the quotas to get their act in order. I don't know why I'm asking you about the automobile industry. That's a little unfair.

Mr. HECKERT. I'm in the same boat. I don't know why either. [Laughter.]

I would suggest that they have made some progress on labor costs. I would suggest they need to make more. I think they have done some good things on product mix and in streamlining their manufacturing operations. And some of the current product is really quite attractive.

Now the problem hasn't totally gone away, and that's not all their fault. There are some overseas considerations that have to be dealt with too. I would certainly encourage forthrightness and patience. We forget sometimes when a major industry like automotive is in some difficulty that just disciplining them or just letting them go down the tube or whatever you decide in your ultimate wisdom, that doesn't completely solve our problem. There are huge ripple effects.

The automotive industry is roundly 10 percent of our GNP. It's a very important outlet for our goods in the chemical industry. It's an important outlet for steel. It's very important to the electronics industry. And when we lose car sales, domestic car sales, the whole country hurts a little. Now this gets into the very tough question of how do you deal with dislocations like automotive got into. Do you have a national industrial policy? Or do you have some behind the scenes meetings? I'm not sure any of us are quite sure of that answer.

What my personal conviction is that an industry over a significant period of time finds itself needing protection really needs to come up with some quid pro quos. They have really got to face the fact that if they are eating at the public trough they owe the public some reasonable effort in all areas to get out of that condition.

I think we shouldn't just pick on automotive there. There are many industries that have problems. So I think most managements today are ready to agree with that general conclusion. That when you are on the public dole, you really owe society some pretty significant exchanges, some quid pro quos. You have got to be good managers. You certainly shouldn't expect your people to settle for the wages they do in Korea necessarily. That's silly. But you certainly have to look at the question—are our wage and salary and compensation policies overall generally in keeping with the rest of the U.S. business? That's an example. It may or may not be terribly important. Are our plants modern? Have we really done the best we can to help ourselves with productivity and innovation?

There is a checklist of things that need to be considered by Government and by the industry in difficulty when you get down to this question of: "If I get protection, what can I do to make it temporary and eventually stand on my own feet."

If I might add just one sentence. I do not think a national industrial policy with Government trying to deal with these questions and developing its own answers is very likely to work. I do think much better dialog and a little more forthrightness may be quite helpful.

Senator CHAFEE. One last question. It seems to me that anybody that visits New York or any of those cities can see that it is swarming with Japanese who are salesmen and who are out hustling and peddling their goods. Without putting you on the spot, you are a big national company, international company, that tries to compete and does compete, just out of curiosity, how many people in your company speak Japanese fluently?

Mr. HECKERT. Fluently? Well, all our Japanese employees do. [Laughter.]

Among our American transferees, I can think of one, and he was over there during World War II and he got quite fluent. And I can think of several, including wives of transferees, that have gotten enough competency so they can at least assure themselves that the interpreter is telling the truth. But, you know, that's a problem.

Senator CHAFEE. I mean I'm not being critical, but it just seems to me that the Japanese I have talked to—like everyone I have been to Japan and talked with the members of the American Chamber of Commerce in Tokyo, and they lament the fact that the Americans seem to have lost the salesmanship abilities that once came. And that we go over there and try and peddle our goods, but we don't put the energy and expertise in the language abilities into it that the Japanese, when they hustle over here, do. Do you think that's a fair criticism?

Mr. HECKERT. Senator Chafee, let me give you some comfort on that. The DuPont Co. is doing extremely well in Japan. That business is growing faster than any other round the world. And we do not find the language barrier a serious problem. It is our policy, to the extent we can, to hire nationals to both run the business and command the business so that the language thing is really not that serious.

I don't think that is as much a real problem as perhaps it is perceived to be. On the other hand. I personally am embarrassed when I go to Europe and my European business host speaks five languages and I have difficulty with English. We all feel a little inferior in that circumstance. The truth is we adapt rather well. And that isn't a large barrier to international commerce.

Senator **Chafee**. Well, thank you very much.

Senator **Danforth**. Thank you very much, Mr. Heckert.

Mr. **Heckert**. Thank you.

Senator **Danforth**. Next we will have together Mr. Merlin Nelson, vice chairman of AMF; and Mr. Leigh Miller, president of American Express Export Credit Corp.

Senator **Chafee**. Mr. Chairman, are these bright lights necessary? If it's a choice between TV coverage and the like, obviously, we will take the TV coverage. [Laughter.]

You have all the ones except the ones that are in my eyes. [Laughter.]

Senator **Danforth**. Mr. Nelson, would you proceed, please?

STATEMENT OF MERLIN E. NELSON, VICE CHAIRMAN, AMF, INC., WHITE PLAINS, NY

Mr. **Nelson**. Mr. Chairman, I'm Merlin Nelson, vice chairman of AMF. In most of the 24 years that I have worked for AMF it has been in the international sector, including 9 years resident in London, England, while I was vice president in charge of the international group of AMF.

AMF is a U.S. multinational corporation with annual sales of about $1 billion. Our business is concentrated in industrial technology and leisure products. I am also a member of the Emergency Committee for American Trade.

As an international businessman, I am most concerned with the mounting U.S. trade deficit. It is increasingly difficult for AMF to sell its many products in world markets. In very substantial part, this is because of the of the overvalued dollar, as Mr. Heckert so eloquently explained.

This overvaluation has had an impact directly on AMF. For example, between 1978 and 1980, AMF exports grew from $61 million to $110 million. And these exports increased as a percentage of total AMF sales from 10 to 16 percent. Since 1980, however, during the period of the dramatic increase in the value of the dollar, AMF exports have declined by almost 30 percent to $80 million, which represented less than 12 percent of AMF's total sales in 1983. There is no question the overvalued dollar is dramatically adversely impacting the fortunes of AMF.

While there are some dissenters, there appears to be both in the business and academic communities a consensus that the U.S. budget deficits are the root cause of the dollar overvaluation. The high U.S. interest rates that are a consequence of the budget deficit are magnets for foreign short- and long-term investments in the United States. These investments help shore up the exchange value of the dollar to the distinct disadvantage of the U.S. international business community. And I think as Mr. Heckert commented, what we really have here as the problem here today is the problem of the bifurcated dollar. On the one hand it's a commodity that is being traded by itself. On the other, it's supposed to be settling international trade transactions. And the latter is being hurt by the valuation that is placed on the dollar as the commodity in international capital markets.

Another facet of the trade deficit problem is the apparent undervaluation of certain key foreign currency, particularly the Japanese yen. While the recent agreement with Japan that is intended to internationalize the yen undoubtedly will be helpful in the long run, I believe that more needs to be done, particularly in respect to Japanese interest rates. Japan utilizes the postal savings system which provides extremely low rates, tax exempt to both savers and borrowers. Until the postal savings system is changed or at least the interest rate lid has been removed, Japanese interest rates will continue artificially low. This will continue the disincentive to investments in Japan and will help keep the yen artificially undervalued, thus adding to the woes of the dollar. I recommend, therefore, governmental discussions with Japan to see whether progress is possible in this very important area.

Now the third area is the developing countries' debt problem. This is making us all, I'm sure, very uneasy and nervous in the business community. Now these countries accounted for about 40 percent of U.S. exports recently, but with the mounting debt and increasing difficulties in servicing it, both their economies and ours are suffering through mutual reductions in our respective export industries.

In 1980, for example, AMF exported $14½-million worth of goods to Latin America. In 1983, this volume had declined by 45 percent, to $8 million.

I imagine that among the appropriate solutions to the debt problem are improved lending authorities for the international lending agencies, particularly the IMF and the World Bank, and both bilateral and multilateral consortiums to accommodate the crushing problems of the largest debtor countries, such as Brazil, Argentina, and Mexico. Perhaps extensions of debt maturities or some sort of limitations on interest payments might be deemed feasible through international agreements. Together with reductions in U.S. budget deficits and U.S. interest rates, such LDC debt measures might accommodate the needs of both creditor and debtor nations. In effect, it seems to me that this is a Government problem and not a problem to be left to the banks and the financial people to resolve.

Finally, much can be done by the U.S. Government to help us in the business community to become more competitive internationally and thus cut back on our foreign trade deficit. We believe that export controls can both be safely reduced in scope and administration. The Government can also help by resisting such protectionist trade measures as domestic content so that foreign retaliation will not further disadvantage our foreign business.

Finally, we should seek improvements in the GATT that will both facilitate trade and provide new rules for international investment and international trade and services.

Thank you.

Senator **Danforth**. Thank you, sir.

[The prepared statement of Mr. Nelson follows:]

STATEMENT OF MR. MERLIN E. NELSON ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE BEFORE THE SENATE FINANCE COMMITTEE HEARING ON THE TRADE DEFICIT

Thursday, June 28, 1984

Mr. Chairman, Good morning. I am Merlin E. Nelson, Vice Chairman, AMF Incorporated. Most of the twenty-three years I have worked for AMF have been in the international sector, including nine years residence in London, England, while I was Vice President in charge of AMF's international operations. AMF is a United States multinational corporation with annual sales of about $1 billion. Our business is concentrated in industrial technology and leisure products. I am also a member of the Emergency Committee for American Trade.

As an international businessman I am most concerned with the mounting U.S. trade deficit and with the many apparent causes of it. It is increasingly difficult for AMF to sell its many products in world markets. In very substantial part this is because of the overvalued dollar. In a statement earlier this month before a Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, Mr. Fred Bergsten stated that the main cause of the merchandise trade deficit is the "massive overvaluation of the dollar." Mr. Bergsten stated that the dollar is currently overvalued by at least 25%. He went on to say that "more and more American firms are finding themselves unable to compete when saddled with the equivalent of a 25% tax on all exports."

Unfortunately, AMF's results confirm the accuracy of Mr. Bergsten's statement. Between 1978 and 1980, AMF exports grew from $61 million to $110 million and these exports increased as a percentage of total AMF sales from 10% to 16%. Since 1980, however, during the period of the dramatic increase in the value of the dollar, AMF exports have declined by almost 30% to $80 million, which represented less than 12% of AMF's total sales in 1983. There is no question the overvalued dollar is dramatically adversely impacting the fortunes of AMF.

While there are some dissenters, there appears to be both in the business and academic communities a consensus that the U.S. budget deficits are the root cause of the dollar overvaluation. The high U.S. interest rates that are a consequence of the budget deficit are magnets for foreign short and long term investments in the United States. These investments help shore up the exchange value of the dollar to the distinct disadvantage of the U.S. international business community.

I commend you, Mr. Chairman, and your colleagues for your efforts in devising measures to correct the budget deficit. Current and projected budget deficits, however, offer little solace that the deficit problem is likely to be brought under significant control. Until it is, we can expect a continued overvaluation of the dollar and consequent huge foreign trade deficits.

Another facet of the trade deficit problem is the apparent undervaluation of certain key foreign currencies, particularly the Japanese yen. While the recent agreement with Japan that is intended to internationalize the yen undoubtedly will be helpful, I believe that more needs to be done, particularly in respect of Japanese interest rates. Japan utilizes a postal savings system which provides extremely low rates to both savers and borrowers. Until the postal savings system is changed, Japanese interest rates will continue artifically low. This will continue the disincentive to foreign investments and will help keep the yen artificially undervalued, thus adding to the woes of the dollar. I recommend, therefore, governmental discussions with Japan to see whether progress is possible in this important area.

The developing countries' debt problem makes me and my business colleagues extremely nervous. U.S. export business with the industrial countries is rather stagnant. Until recently, however, our exports to the developing countries were booming. These countries account for about forty percent of U.S. exports. But with mounting debt and increasing difficulties in servicing it, both their economies and ours are suffering through mutual reductions in our respective export industries.

The debt crisis in Latin America, for example, has adversely impacted AMF's sales to this area of the world very materially. In 1980 AMF exported $14.5 million worth of goods to Latin America. In 1983 this volume had declined by 45% to $8 million.

I imagine that among the appropriate solutions to the LDC debt problem are improved lending authorities for the international lending agencies, particularly the IMF and the World Bank, and both bilateral and multilateral consortiums to accommodate the crushing problems of the largest debtor countries such as Brazil, Argentina, and Mexico. Perhaps extensions of debt maturities or some sort of limitations on interest payments might be deemed feasible through international agreements. Together with reductions in U.S. budget deficits and U.S. interest rates, such LDC debt measures might accommodate the needs of both creditor and debtor nations.

Much can be done by the U.S. government to help us in the business community become more competitive internationally and thus cut back on our foreign trade deficit. We believe that export controls can both be reduced in scope and administration. While the administration of U.S. export controls has materially impacted AMF's exports, I am sure the loss by the Caterpillar Tractor Co. of a potential sale of 200 pipe layers with a value of approximately $250 million is a much more dramatic example of the devastating effect that these controls can have on a company and more importantly on the level of unemployment in the U.S. The irony of the situation is self-evident since the action restricting Caterpillar's exports in no way adversely affected the Russians who were able to obtain the necessary pipe layers from Caterpillar's arch rival Komatsu.

The government can also help by resisting such protectionist trade measures as domestic content so that foreign retaliation will not further disadvantage our foreign business. The tax code should be examined to see whether it can be revised in order to enhance our competitive position and we should seek improvements in the GATT that will both facilitate trade and provide new rules for international investment and international trade in services.

STATEMENT OF LEIGH M. MILLER, PRESIDENT, AMERICAN EXPRESS EXPORT CREDIT CORP., NEW YORK, NY

Senator DANFORTH. Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman, members of the committee. My name is Leigh Miller, and I am president of American Express Export Credit Corp. I appear here today on behalf of the National Foreign Trade Council, of which I am a director. I am accompanied by Mr. Richard Roberts, who is president of the National Foreign Trade Council.

I also appear as someone who is directly involved in a practical sense in the trade and services as an export financing company.

The National Foreign Trade Council is an association of nearly 600 companies engaged in international trade and investment. Collectively, these companies account for over 70 percent of U.S. nonagricultural exports. I will shorten my presentation to conserve the committee's time, but a full presentation has been given to the committee.

Our members endorse this committee's inquiry into the causes of the trade deficits and possible actions which might be taken to reduce it. With respect to the magnitude of the 1984 trade deficit, we anticipate that it will be in the $100 to $140 billion range. The principal causes, as we see it, of the deficit are: One, the strong dollar; two, the accelerated pace of economic recovery in the United States in advance of the rest of the world economy; three, reductions in imports by high debt developing countries; four, foreign government intervention in trade.

First, the strong dollar. Since 1978, the dollar has risen by roughly 40 percent against key foreign currencies, thereby making American goods and services more expensive with the accompanying adverse effects for both exports and the import competing sectors of our domestic U.S. market. Several factors have contributed to the strength of the dollar. One is the safe haven effect; another is high U.S. interest rates which have produced very substantial capital flows from abroad. U.S. high interest rates are themselves attributable to a number of factors, and most important of which, in our view, is the Federal budget deficit. Unless these capital inflows resulting from the high dollar and high interest rates are reversed, the United States will soon become a debtor country.

Second, the recovery in the United States has been both stronger and earlier than the recovery abroad. The result is that imports into the United States have surged whereas the demand for our goods and services abroad still lags.

Third, higher oil prices and interest rates coupled with a world recession have left many developing countries with major external debt problems. To service these debts, debtor countries conserve more in foreign exchange through reductions in imports. According to a report by the Joint Economic Committee, U.S. exports to eight high debt Latin American countries fell by 27 percent from 1982 to 1983.

Fourth, difficulties in adapting to new competitive realities and the slow recovery from the recent worldwide recession have generated protectionist pressures as country after country seeks to preserve its home market for domestic producers, expand markets abroad, and limit import competition.

Let me discuss some of the actions which are necessary in our view. Because the strong dollar contributes significantly to the trade deficit, a major objective of our economic policy must be to bring about an appropriate and orderly reduction in the exchange rate value of the dollar. One of the principal causes of the high interest rates which now sustain the dollar is the large Federal budget deficit. Therefore, steps to reduce budget deficits must be a matter of the highest priority. The enactment of the down payment program yesterday, which we strongly supported, will be an important beginning. But in view of the magnitude of future projected deficits, we think it is essential that Congress undertake a bipartisan effort to institute immediate further reductions in spending and in entitlement programs. Problems generated by the strength of the dollar are not only for the U.S. industry, but for the international trading system and are of considerable magnitude and would, themselves, justify convening in our view an international conference on monetary stability.

But even if the dollar becomes progressively less strong, that development alone will not be sufficient to restore U.S. exports. Until economic growth in the industrialized nations and the developing world accelerate, there simply will not be a market abroad for all of the products which we desire to export and which many countries so desperately need.

With respect to the third factor which contributes to the deficit, the inability of developing countries burdened by debt to purchase exports, there are a number of actions the United States has taken or should take to assist them. One is to continue to pay our fair share of the amount needed by the international monetary fund and multilateral development banks to provide loans to developing countries. The United States must maintain the generalized system of preferences to take the lead in reducing trade barriers which impede developing country exports.

The Council, therefore, supports action by Congress to renew the GSP system. Turning to the problem of foreign government intervention in trade, another important step the United States can take to reduce the trade deficit is to bring greater pressure to bear on our trading partners. GATT must be supported. At the same time, our Government and U.S. companies injured by unfair foreign trade practices should continue to invoke and enforce U.S. domestic trade laws.

In summary, I would like to say that the trade deficit is mainly the result of a combination of macroeconomic factors, many of which are only partly within our control. Because our country's economic health depends to a growing extent on our ability to export and meet foreign competition, the actions which we have identified should be promptly taken.

Thank you very much.

[The prepared statement of Mr. Miller follows:]

STATEMENT OF
NATIONAL FOREIGN TRADE COUNCIL INC.
BEFORE THE SENATE FINANCE COMMITTEE
HEARINGS ON U.S. TRADE DEFICIT
JUNE 28, 1984

My name is Leigh Miller. I am President of American Express Export Credit Corporation. I appear here today on behalf of the National Foreign Trade Council, of which I am a Director. The Council is an association of nearly 600 companies engaged in international trade and investment; collectively these companies account for over 70% of U.S. non-agricultural exports.

Our members endorse this Committee's inquiry into the causes of the trade deficit and possible actions which might be taken to reduce it. Unless there is a clear understanding by policy makers and the public of the factors underlying the deficit, there is a danger that inappropriate and counterproductive remedies may be adopted which will retard rather than improve our trade performance.

With respect to the magnitude of the 1984 deficit, we anticipate that it will be in the $100-$110 billion range. The principal causes of the deficit are

(1) the strong dollar
(2) the accelerated pace of economic recovery in the United States, in advance of the rest of the world economy
(3) reductions in imports by high-debt developing countries
(4) foreign government intervention in trade.

I will address each of these in turn.

First, the strong dollar. Since 1978 the dollar has risen by roughly 40% against key foreign currencies, thereby making American goods and services more expensive with adverse effects for both exports and import-competing sectors of our domestic market. Several factors have contributed to the strength of the dollar, and, as this Committee knows, there have been considerable differences among analysts as to the relative importance of each. One is the 'safe-haven' effect. Another is high U.S. interest rates: the attractive real, after-tax rate of return on U.S. investments has produced very substantial capital flows from abroad. High U.S. interest rates are themselves attributable to a number of factors, the most important of which, in our view, is the Federal budget deficit--present and anticipated borrowing needs of the federal government in competition with the borrowing needs of the private sector coupled with inflationary expectations have maintained upward pressure on interest rates. The difference between our national pool of savings and the borrowing needs of the government and the private sector is presently being financed by capital flows from abroad. Thus our growth is being sustained through policies which hinder the growth and economic well-being of the rest of the world. Moreover, unless this trend is reversed, the United States will soon be a debtor country.

Second, the accelerated growth of the U.S. economy. The recovery in the United States has been both stronger and earlier than the recovery abroad with the result that imports into the United States have surged, whereas the demand for our goods and services abroad still lags. While the growth of the domestic economy is a positive development for domestic producers and helps the economies of many nations which export to us, the effect on the U.S. trade balance is negative. As the pace of recovery advances abroad, the demand for U.S. exports will rise significantly.

Third, severe reductions in imports by debt-ridden developing countries. Higher oil prices and interest rates coupled with a world recession have left many developing countries with major external debt problems. To service these debts debtor countries institute austerity programs, conserving foreign exchange through reductions in imports. According to a report by the Joint Economic Committee, U.S. exports to eight high-debt Latin American countries fell by 27% from 1982 to 1983. And between 1981 and 1983 our trade balance to those countries deteriorated by $20 billion.

Fourth, foreign government intervention in trade flows. Difficulties in adapting to new competitive realities and a slow recovery from the recent worldwide recession have generated protectionist pressures, as country after country seeks to preserve its home market for domestic producers. In addition, national industrial policies, effected through state-owned corporations, export subsidies and home-market protection, endeavor on the one hand to expand markets abroad and on the other to limit import competition.

While it is difficult to put a price tag on foreign government intervention in terms of its effect on U.S. trade, it is fair to say that both our exports and domestic sales would increase significantly if foreign governments reduced overt and indirect intervention in trade flows and fully complied with the international trading rules set forth in the General Agreement on Tariffs and Trade.

Having identified the major factors which contribute to the trade deficit, let me discuss some actions which are necessary to reduce it.

Because the strong dollar contributes significantly to the trade deficit, a major objective of our economic policy must be to bring about an appropriate and orderly reduction in the exchange rate value of the dollar. One of the principal causes of the high interest rates which now sustain the dollar is the large federal budget deficit. Therefore, steps to reduce the structural deficit in the Federal budget must be a matter of the highest priority. The enactment of the "down payment" program now before the Congress, which we strongly support, will be an important beginning, but in view of the magnitude of future projected deficits, we think it essential that Congress undertake a bipartisan effort to institute immediate further reductions in spending and entitlement programs.

Some argue that the flexible exchange rate system has contributed to the wide movement of the dollar, and that a return to fixed exchange rates would therefore be desirable. We doubt that a fixed exchange rate system would have been able to maintain the dollar at the level it was several years ago because fixed exchange rates that diverge from the market level can be sustained only over relatively short periods. They must be adjusted to reflect fundamental economic conditions in participating countries. While there is no broad consensus that a return to fixed exchange rates is desirable, the problems generated by the strength of the dollar not only for U.S. industry but for the international trading system are of considerable magnitude, and would justify convening an international conference on monetary stability.

But even if the dollar becomes progressively less strong, that development alone will not be sufficient to restore U.S. exports to satisfactory levels. Until economic growth in the industrialized nations and in the developing world accelerates, there simply will not be a market abroad for all the U.S. products which we desire to export and which many countries so desperately need. The management of the economies of the industrialized nations is outside our control, although at meetings such as the London economic summit the United States has sought agreement on common policies to widen the recovery and stimulate non-inflationary growth. Forceful action by the United States to put its own economic house in order through reduction of the Federal budget deficit would, in our view, do much to enhance the credibility of the economic policy recommendations which we make to other industrialized nations.

With respect to the third factor which contributes to the trade deficit, the inability of developing countries burdened by debt to purchase exports, there are a number of actions the United States has taken or should take to assist them in resuming economic growth. One is to continue to pay our fair share of the amounts needed by the International Monetary Fund and multilateral development banks to provide loans to developing countries.

Another is to take the lead in developing a program to prevent further damage to the economies of less developed countries from a significant increase in interest rates. Too much time and effort has been spent in trying to point the finger of blame for the LDC's economic problems; insufficient attention has been given to developing creative solutions. We support efforts to give assurance to the LDC's that the difficult and painful economic steps taken in conjunction with an IMF or other austerity program will not be wiped out by further increases in interest rates.

Also, the United States must maintain the Generalized System of Preferences and take the lead in reducing trade barriers which impede developing country exports. It is now a well known fact that nearly 40% of U.S. exports of manufactured goods are purchased by developing countries; unless we are willing to buy their products and participate in efforts to strengthen their economies, that export market will continue to falter. The Council therefore supports action by Congress to renew the GSP system; while the short-term impact on the trade deficit may be neutral or even slightly negative because the bill will encourage rather that discourage imports, the long-range impact of the bill will be positive, as the ability of debtor nations to pay for imports increases.

Turning to the problem of foreign government intervention in trade, another important step which the United States can take to reduce the trade deficit is to bring greater pressure to bear on our trading partners to maintain an open international trading system.

The effort must proceed on several fronts simultaneously, and it must be unceasing. First, in international organizations and forums such as the economic summit meetings, the OECD and the General Agreement on Tariffs and Trade ministerial conferences, the United States must work to establish stronger commitments by the parties to reduce or eliminate barriers to trade. Because the GATT constitutes a set of internationally agreed rules to discourage tariff and non-tariff barriers to trade, it should be strongly supported by the United States. We recommend that the United States press our trading partners to set a date to institute a new round of multilateral trade negotiations which would address, among other things, trade in services and high technology. In addition, we should work to strengthen GATT's enforcement powers, so that violations are promptly dealt with. Gradually, too, through the GATT or some other multilateral institution, rules must be formulated to reduce investment restrictions prevalent in many countries which not only impede trade but also operate as barriers to open markets.

Second, our government and U.S. companies injured by unfair foreign trade practices should continue to invoke and enforce domestic U.S. trade laws. These laws provide relief from injurious surges in imports and through the mechanism of countervailing or antidumping duties provide offsets against dumping or export subsidies in the U.S. marketplace. In this connection we urge that Congress enact the Reciprocal Trade and Investment Act(S.144) which would strengthen the power of the President to negotiate reductions in barriers to trade, including trade in services, and trade-related investment restrictions imposed by foreign governments.

While we strongly favor vigorous enforcement of the trade laws, we believe, however, that they should be regarded as instruments to provide breathing space for adjustment rather than as long-range solutions to the challenge of foreign competition. Among other reasons, these laws apply generally only to imports into the United States, and therefore do not protect U.S. producers in third country markets. If U.S. industry is to compete successfully in those markets it must find a way to meet the competition of products and services from countries which provide government assistance to domestic producers.

In addition to invoking the GATT and our trade laws, bilateral trade negotiations offer an important avenue for reducing barriers to trade. Determined, persistent negotiating efforts by the USTR and the Commerce Department, and other Departments and agencies, have defused trade conflicts and effected reductions in foreign protectionism. Such negotiations should be continued and indeed accelerated.

While we favor the enforcement of existing trade laws and support vigorous efforts by our government to achieve reductions in foreign government intervention in trade, we have strong reservations about imposing additional restrictions on imports beyond those permitted under existing law. Accordingly we are opposed to "domestic content" legislation (S.707) and to proposals which would impose tariffs or quotas on imports. We also have strong reservations about trade remedies legislation (H.R.4784) which would create a new class of unfair trade practices not now covered by the GATT. New import restrictions are likely to protect one industry at the expense of imposing higher costs on another, or protect one industry while exposing others to retaliatory or mirror-image legislation abroad. The economy as a whole is best served by avoiding import restrictions, but it should be recognized that some of our industries have been severely damaged by foreign competition and yet are confronted with inequitable barriers to doing business abroad. If calls for protectionism and eye-for-an-eye trade retaliation are to be resisted, our government must act firmly and quickly to address unfair trade restrictions imposed by foreign governments.

There are strong differences of opinion as to whether the goods and services produced by American industry are competitive in world markets. We do not subscribe to the thesis advanced by some that U.S. industry is uncompetitive. While there are sectors of the economy which continue to face special adjustment problems, particularly those in competition with the newly industrialized countries, our country's overall competitive performance has improved significantly in the last several years. The new spirit of competitiveness is characterized by advanced production methods, heavy emphasis on quality, higher productivity by workers and managers, and the adoption by many firms of a global strategy. The U.S. work force in particular is to be commended for exercising restraint in wage negotiations.

While the recent recession and the challenge of foreign competition have brought significant positive changes to American industry, including higher productivity, there is no room for complacency. Unless the United States develops a coherent and comprehensive strategy to meet the competitive challenge presented by other nations, a deterioration in our nation's trade performance and ultimately in our economic growth can be anticipated. This national effort must have several components: one, we need more investment in plant, equipment and technology. In particular, tax incentives to encourage savings and investment in productive plant, equipment and technology will significantly enhance U.S. industry's ability to compete in international markets.

Secondly, there are signs that our country is having difficulty maintaining leadership in technology. The United States has long excelled in science and technology, but action is needed to stimulate both the growth and the dissemination of technology as a means to enhance competitiveness. Tax, antitrust and patent laws should be amended to provide greater stimulus for research and development. We support legislation pending in Congress to provide antitrust exemption for joint research ventures. Both at home and abroad, a continued effort is necessary to protect intellectual property rights. And unreasonable regulatory delays and requirements which inhibit the utilization of new technology should be revised.

Third, the American workforce must be better prepared to adapt to change. There is a shortage of workers adequately trained in science, engineering and mathematics. Millions of displaced workers must learn new skills. Disadvantaged workers whose basic education is inadequate must be assisted to meet the challenges of rapid change and new technology. A better educated, more productive workforce should be a high priority national goal.

Fourth, action must be taken to reduce disincentives to exports, and to counter foreign government actions aimed at conferring special advantages on their own producers. Over-regulation by our own government continues to dull the competitive edge of American business. The Council welcomes steps taken over the past year by Congress and the Administration to reduce disincentives to international trade and investment. Regulatory burdens remain, however: export controls should be modified; antibribery laws should be clarified; environmental standards should be reviewed for cost and benefit effectiveness; and the application of trade embargoes should be subject to a congressional review process.

With respect to countering foreign government actions to stimulate exports, I have already referred to the necessity that our government move vigorously against foreign government export subsidy programs which violate the GATT and our own trade laws. In addition, until our trading partners agree to terminate government-subsidized export financing, allowing private capital markets to determine export credit interest rates and repayment terms, the Export-Import Bank of the United States must receive sufficient authorization to remain financially competitive. Meanwhile, international negotiations must be continued to reduce and ultimately eliminate official export credit financing, including mixed credits. The newly industrialized countries must be encouraged to follow the export credit guidelines of the OECD.

In addition, our tax policies should be designed to support, not impair the competitiveness of U.S. products in international markets. As this Committee considers proposals to simplify the U.S. tax system, it is important that the effects of the proposed changes on companies having substantial international operations be examined so that special additional burdens are not placed on those companies which would impair their ability to successfully compete in the international marketplace.

In summary, the trade deficit is mainly the result of a combination of macroeconomic factors, many of which are only partly within our control. Nevertheless, there are a number of actions which the United States can and should take that will significantly reduce the trade deficit over time. Because our country's economic health depends to a growing extent on our ability to export and to meet foreign competition, those actions, which we have identified, should be promptly taken.

Thank you.

Senator DANFORTH. Gentlemen, thank you very much. You have been good enough to testify together. The reason I asked you to testify together is that you both touched on a subject which I think deserves special attention. That is the situation with respect to the lesser developed countries, which, as you have pointed out, have accounted for about 40 percent of our export sales.

I do not pretend to be an expert on this subject at all. But I do understand that the debt problem of this country is directly related to our trade situation here in the United States. Countries which have been excellent markets for the United States have gotten deeply in debt. They have had a hard time making payments on that debt. They have been under pressure by the IMF to get their economic houses in order. We have supported the IMF. Part of getting their economic situation fixed up has been to try to reduce imports into their countries and to try to increase exports, even to the point of dumping what they are producing.

Our economy depends on having those markets available and having healthy economies in those countries so that they can buy U.S. goods. You have pointed out, Mr. Miller, the importance of reauthorizing the GSP. I couldn't agree more, and I hope there is some way we can do that between now and the end of this year.

But I wonder if you have any other suggestions as to what to do about the LDC's. They, obviously, are jolted every time the prime rate goes up in the United States. That, in turn, is related to our budget deficit. But sometimes if you are faced with a particular problem you sort of have a global solution and nothing gets done. I wonder if there is anything that we can do. We are working on the deficit, and we have passed the tax bill, and we are going to continue to work on the deficit. But that is going to be a long, long, long fight.

I wonder if you have any more specific answers as to what to do about the LDC's. I mean the prime rate now is what, about 9 points over the inflation rate? The historic spread is about 3 points. I wonder if something could be worked out so that we don't just clobber the LDC's and increase the pressure on them to restrict imports and to dump exports.

Mr. MILLER. First, in our judgment, and the greatest problem of the LDC's, is interest rates, as you pointed out, Mr. Chairman. We made some recent calculations that indicate that, if interest rates are 13½ percent—just a little bit more than they are at the present time—for the years 1984 to 1986, and the OECD countries' growth is 2½ percent—not much below what it is right now—the interest rate burden of the LDC's will double by 1986. Now that's an immense burden for them to carry. And when they are, in fact, transferring real resources to us rather than the other way around—interest rates must be the first priority. Therefore, we have noted that we think at least some contingency planning should be put in place as soon as possible to prevent further damage to the economy of the LDC's from a significant increase, at least, in interest rates. There have been many proposals to assist in this, but we do think that we must take action now. I have a personal proposal. There are hundreds of proposals that have been made, but the proposal should include the following elements: That it not be just the United States, but it be a multilateral approach;

that it use existing multilateral or existing organizations to administer it; and that it should give cash flow assistance to the problems of LDC's making payments.

[The following additional statement was submitted for the record by Leigh M. Miller.]

LDC HIGH INTEREST SAFETY NET

The impact of the international financial crisis arising from large LDC debts is now reaching its second anniversary. Although some progress has been made in a few countries, the threat is again looming large - mainly because of increases in world-wide interest rates.

The LDC's desperately need protection against significant increases in interest rates. It has been estimated that each 1% increase in interest rates adds $3-4 billion to the external debt burden of the LDC's. This added load is outside of the control of the LDC's. At the end of 1983, the seven largest Latin American debtors had total external debts of more than $300 billion. Interest on the debts was equal to more than 40 percent of their export earnings, and scheduled principal repayments bring the total to about 60 percent of their foreign exchange revenues.

The IMF was created to address short term, balance of payment and financial adjustment problems for one or a few countries at a time. Unfortunately, it does not have the financial resources to deal with a crisis of this magnitude which involves the entire world's financial system.

However, the developed countries can take actions which will alleviate some of these problems. These countries - led by the U.S. - can adopt economic policies which lower interest rates and avoid protectionism. Such policies would not only assist the LDC's by reducing the cost of their debt burden, but also they would allow the LDC's to expand their exports and earn more foreign exchange.

At the present time, the world's banks are being required to lead the negotiation process because they have the most money which has been loaned to LDC's. However, LDC's need economic reform to achieve stability and growth, and that is a political problem as well. Banks cannot negotiate economic reforms in the LDC's without being involved in internal politics and foreign policy. Governments must take the lead to work toward political as well as economic solutions. Too much time and effort has been spent in trying to point the finger of blame for the LDC's economic problems; insufficient attention has been given to developing creative solutions. The world's financial crisis is too important to be left in the hands of the bankers, to paraphrase Clemenceau.

At the very least, governments should make contingency plans against the possibility of a rapid rise in interest rates. The U.S. Government should take a leading role in addressing the problem: it can provide powerful leadership and mobilize sufficient resources to provide a safety net against important, world-wide interest rate increases for those LDC's that are making real progress. U.S. economic policy is the most important ingredient in world interest rate levels and our leadership should reflect that fact. The LDC's should receive assurance that their economic gains achieved at great political and economic cost will not be eliminated by interest rate rises beyond the present level.

However, an actual reduction of interest rates below market levels for a favored group of LDC's would have a significant and adverse effect upon the world financial markets. Therefore, the restructuring should put a cap on the cash flow from the LDC's to their creditors at a reasonable level. The real problem created by an increase an interest rates is the accompanying increase in amounts of scarce foreign exchange which must be paid by the LDC to its creditors without any offsetting gain from receipt of goods or services. Fortunately, in the short run, the increase in costs due to interest rates can be offset by restructuring principal repayments through lengthening of the loan maturities. In the long run, the advantageous financial policies which must accompany any loan restructuring will provide the economic base to pay off the loans which have been rescheduled.

The leader in designing an interest rate safety net must be the U.S. Government: the thousands of lending banks around the world cannot; the IMF, BIS, World Bank and other financial institutions do not presently have sufficient resources to give assurance of a safety net without holes. The U.S. Government, along with its allies, has the size, importance and world position to provide the necessary guidance.

A high interest rate safety net to help limit damage to LDC economies should have the following characteristics:

- It should be multilateral - all OECD countries should participate.

- It should be used only to the extent that there is an existing IMF program in place.

- It should guard against a significant increase in rates from their present level with a clear, precise trigger - probably a rise in dollar interest rates above 11% per annum.

- It should not unduly penalize banks' earnings - otherwise international private lending will be cut off, making the crisis a self-fulfilling prophesy.

- It should restructure existing loans by maintaining interest payments at market rates - following the lead of U.S. variable rate mortgages or the recent World Bank cofinancing schemes - and avoid bank loan write-offs of loans with resultant lending reductions.

- It should use existing institutions - each OECD country can use its governmental export lending or guarantee agency to avoid new bureaucracies and endless confusion.

- In order to limit the cost of floating rate loans, banks should reduce the spreads that they charge and the OECD governments should guarantee the principal payments of the loans that have been restructured and postponed.

- It should apply to short term trade finance as well as long term loans - use of existing governmental export programs at coordinated and capped rates in much larger volumes would be one road to achieve this. Although this would involve a subsidy because the new short term, trade loans will have a ceiling below market rates, many such government export programs already have subsidies and this approach would follow those principles. Without assisting exports to the LDC's, their ability to generate the increase in foreign exchange income will be severely impeded.

If the foregoing principles are used by the OECD countries to develop a coordinated safety net for LDC's, it will provide an incentive for the LDC's to take the difficult steps necessary to achieve growth and service their debt at the same time. Without such a contingency plan a significant increase in interest rates will jeopardize the entire world's financial structure.

Leigh M. Miller

Mr. NELSON. I might just add this. That I think maybe this is not a very good analogy, but the comparable situation is the chapter 11 situation here in the United States, the national bankruptcy law. And what you have to have is some authority. It should be multilateral, as Mr. Miller pointed out, that can basically sit there and rearrange the priorities because there is only so much money there that can be used to pay whatever—call it interest, call it principal. And what we have been doing so far is just watching the IMF and the banks basically go from 3 months to 3 months crises without really dealing with the problem. The problem is a cash flow problem. And you may have to reschedule that debt. You may have to equitize a certain amount of it. But you have got to create a multilateral authority to do it in the first place. And then there should be some quid pro quos in there which will get a certain amount of the available funds of those countries classified in the form of a working capital type of situation which can be used to carry on the business of the country, just as you do in a chapter 11. You arrange for the vital flow of trade to continue.

It seems to me that's the parallel I would suggest.

Mr. MILLER. I would just add, Mr. Chairman, that it is not just a question of trade or, indeed, aid that we are talking about. But we are also talking about the health of the world's financial structure. And there can be—and we are in a dangerous period—possibility of a failure could have repercussions throughout the entire world's financial system.

Senator DANFORTH. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

One of the activities that has taken place, as you know, is the protectionist answer in the United States which involves restraints on various imports and so forth. And what we don't seem to realize so frequently, although we always say beware of retaliation—indeed, there is retaliation. I don't know whether this is accurate, but has your company had some experience in that line, Mr. Nelson, of being the victim of retaliation as a result of what we have done in specialty steel?

Mr. NELSON. No. The businesses that AMF would be involved in would not have been of the size in any particular country where they would focus on it, and act in some sort of retaliatory way.

Senator CHAFEE. I see.

Mr. MILLER. I might say, Mr. Senator, one area which hasn't been given as much attention where there are possibilities for retaliation or domestic control is in the area of data flow. The transborder data flow problems are great, and the world's interdependence depends upon a free flow of data, a free exchange of data; and some countries, including one just to the north of ours, have taken steps which tend to inhibit the free flow of data and the ability to use computers or use information based in other countries. And that is a particularly worrisome problem as far as the service industries are concerned.

Senator CHAFEE. Gentlemen, we would just like to recess here briefly because there is a vote on. It covers 16 votes and 1 vote, so this is fairly important to get to. And we will be right back, if you could just wait.

[Whereupon, at 11:18 a.m., the hearing was recessed.]

AFTER RECESS

Senator DANFORTH. Mr. Miller and Mr. Nelson, I apologize for not letting you go before we went to vote, but I understand that Senator Chafee has no more questions for you. I have no more questions of you. I really appreciate your testimony. It has been very helpful, especially the focus that you have given the question of LCD debt and the effect that that has on U.S. trade. Thank you very much.

Mr. NELSON. Thank you, Mr. Chairman.

Mr. MILLER. Thank you.

Senator DANFORTH. Our next withness is John F. Mitchell, president, Motorola.

STATEMENT OF JOHN F. MITCHELL, PRESIDENT, MOTOROLA, INC., SCHAUMBURG, IL

Mr. MITCHELL. Thank you very much for the opportunity of testifying today on an issue that I think is extremely important to American manufacturing. You have heard all the data on our trade problems; the deficits in trade is likely to reach $130 billion this year. The biggest problem in our trade deficit is in manufacturing. We project that that will reach a $90 billion deficit, and that's a swing of over $100 million since 1980 when we had about a $12 million surplus.

Last year, the United States became a net importer in the electronics arena, and this is a great shock to us. Of course, for years we have known the problems of consumer electronics, but the other portions of the electronic industry is now seeing the problems that we have seen earlier in the consumer arena.

The biggest cause of our trade deficit is the exchange rate. While our trade balance continues to go negative, the dollar continues to strengthen against other currencies. And over the last 4 years that trend has happened every year. High interest rates are a factor. And, of course, when we go through this conversation, we start out with the trade deficit exchange rates, high interest rates and pretty soon we are down to the Federal deficits. And it seems convenient to lay all the problems on the Federal deficit, and hope that somehow that problem can be solved here in Washington.

The interest rate alone, of course, is a major, major component of the Federal deficit, and the trend suggests that it will reach $150 billion this year. And, of course, interests are about twice the historical rate, and a major component, obviously, of the deficit.

It seems to me that the Federal Reserve policy is really in conflict with the administration's supply side policy. We understand the supply side economics in the semiconductor world. When you add capacity, you stimulate demand. Prices go down, the market responds, you add more capacity, prices go down some more, and the market expands. However, if some agency such as the Federal Reserve is attempting to fight inflation—which they have done and done successfully—at the same time by destroying demand it is very difficult to invest in capacity or added supply.

We have heard many times the solution to the deficit problem, or at least one of the potential solutions, is a value added tax. We hear that if we applied a value added or consumption tax across the board on all commodities in the United States and then removed it on exports, as is done in most countries of the world, we could stimulate our export program and solve the deficit at the same time. I believe that that's a very, very bad compromise. I think that the consumers of this country have taken us out of every recession by courageous consumer spending. A much better solution would be to put a tax on that portion of consumption coming across our borders in excess quantities * * * beyond what we can return in goods and services of our own.

There are serious problems elsewhere in the economy that affect the business environment that should also be addressed. Foreign governments are targeting certain segments of our industry. It's very clear the Japanese are targeting the telecommunications industry at this time. We knew a long time ago, of course, after World War II Japan started their targeting program in textiles, steels, shipbuilding. Then they moved up the technology ladder to automobiles, consumer electronics.

For the last 10 years, they have had significant laws and regulations stimulating the development of industrial electronics and machine tools and we now see the result. In the telecommunications industry we have a 22-to-1 deficit with the Japanese, even though we have an NTT agreement that has opened up the Japanese market. We at Motorola are participating in that market. But we are in significant trouble with our problems in that arena.

Are there solutions to the trade deficit problem that don't spiral around the difficult question of interest rates, the Federal deficit, et cetera, and finally come to rest in the question of whether or not we can balance the budget? I believe there are. And I think the most important solution would be to address the imbalance of trade right at the border.

Back in 1971, the U.S. Government decided the exchange rates were out of kilter and our trading partners across the world were pegging their currencies at a lower level than seemed reasonable at the time. The U.S. Government put on 10 percent surcharge, for a period of 9 to 15 months that essentially taxed all goods coming into the country. That solution, it seems to me, would be a solution available today, as it has been in the past. We have seen it work. And we know something like a 20-percent surcharge would add roughly $60 billion of revenue every year to help solve the deficit and interest rate problems.

There are other problems that should of course, be addressed in the solution to our trade problem. Clearly, there should be modified monetary and fiscal policy. Lower the interest rate, balance the budget. Clearly, there are problems opening markets in other countries. We should aggressively negotiate to open markets in other countries or we should in turn raise tariffs on those products coming into this country.

We strongly support your bill, Senate bill 2618, in this regard. We also support the House bill, 4784, that we hope will address the targeting problem.

We think there are stronger programs that could address the general areas of trade inequities. I could go on, but my time has run out. I must say that it is time to change our priorities in this country. We really must address the issues of trade and they must be addressed very soon.

[The prepared statement of Mr. Mitchell follows:]

U. S. TRADE DEFICITS
Presented to the Senate Finance Committee
By John F. Mitchell
President
Motorola Inc.
June 28, 1984

Mr. Chairman and Members of the Finance Committee, I appreciate the opportunity to appear before you today to testify on the trade deficit.

The United States appears headed for a merchandise trade deficit of around $130 billion in 1984 and a current account deficit in excess of $80 billion. (See Exhibit A). The United States has never experienced deficits of this magnitude. Our largest merchandise deficit before 1982 represented only 1.6 percent of GNP compared with 3.6 percent in 1984. This obviously represents a significant drag on the U.S. economy.

America's manufacturing sector has been particularly hard hit. Last year, the manufactures trade deficit was $38.2 billion, compared with a $12.5 billion surplus in 1980. Over the last four years the U.S. manufacturing trade balance declined by more than $50 billion, compared with an overall decline of only $33 billion. Thus, the deterioration of the U.S. trade position in manufacturing has been much more serious than in any other sector. Based on January to April 1984 data, the deficit in manufacturing could approach $90 billion this year, an addition of about $50 billion.

The economic hardships for American workers that result from these recent developments are severe and growing. The Department of

Commerce has estimated that the decline in domestic employment since 1980 related to U.S. exports totalled 1.5 million, equal to about 1/7 of U.S. unemployment in 1983. This loss is virtually all due to manufactured exports and the largest employment losses were in the manufacturing sector. Loss of jobs due to exports represented about half of the total manufacturing jobs lost during 1980-83.

The U.S. International Trade Commission estimates that the labor content of imports rose only slightly from 1980 to 1982 from 5.57 to 5.64 million jobs. With the increase in 1983 imports, additional U.S. jobs losses were recorded. In 1984 a significant upward movement in imports suggests that there will be substantial job impacts. January to April 1984 imports were up 40 percent above the same 1983 period. If sustained, the adverse job impact would be in the range of 1.5 - 2.0 million.

The total effect since 1980 of our deteriorating trade deficit on U.S. jobs could be on the order of 3 to 3.5 million. That represents about one-third of the total U.S. unemployment.

For the first time in history, the U.S. became a net importer of electronics last year. Even the highly competitive nonconsumer electronics sector has not escaped serious erosion -- falling from a surplus of $10.6 billion in 1980 to $7.0 billion 1983. (See Exhibit B).

This dramatic and pervasive decline in the U.S. trade balance, focused in manufacturing, is alarming. We are headed for problems of serious proportions, through the erosion of our U.S. industrial base that is so critical to our economic growth and national security. (See Exhibit C). We are now in deficit with almost all our trading partners. (See Exhibit D). And the gap has increased over the period from 1980 to 1983 with 1984 promising to be much worse. (See Exhibit E).

There are a number of important factors contributing to this rapidly deteriorating trade situation. The biggest problem is exchange rates. We have a monetary policy and a fiscal policy in this country, and although they are in significant conflict, they do exist....but we are the only country in the world without an exchange rate policy, unless you characterize our laissez-faire or free market exchange rate attitude as a policy. (See Exhibit F). While our trade balance continues to go negative with most key partners, our currency is gaining the other way. (See Exhibit G).

It is conventional when discussing trade problems to engage in a circular conversation that starts with exchange rates, moves to interest rates and then to monetary policy and then finally ends with a discussion of Federal deficits. I guess it is easy to lay the problems of our economy and our trade on the runaway deficits in the Federal budget. However, our manufacturing sector will be a shadow of its former self if we wait for a Federal budget surplus to pull trade back into a stable mode. Federal deficits are a tremendous problem, to be sure. (See Exhibit H). We are spending our children's income at a furious pace on exaggerated entitlement programs and on a defense budget that is trying to do everything from Star Wars to reactivating a battle line of 16-inch gun battleships, and neither can be effective in the type of military engagements we have been involved in over the last 35 years. We cannot afford the level of government spending budgeted for the next five years and we better face reality very soon.

In the meantime we have become the dumping ground for the world. While short-sighted economists think that's great for our inflation and U. S. consumers, they apparently do not believe the market system should subsidize the unemployed and retired, and they clearly do not account for the loss in taxes that would be generated by a healthy homegrown or manufactured economy. The lost taxes, unemployed and retired funds must be made up. Ideally, this would be done by being superior in some facet of our economy and, thus, being able to sell our trading partners something equivalent in value to our imports in return for their goods.

A factor in our exchange rate problem is high U.S. interest rates. Our trading partners find our interest rates very attractive for the accumulated dollars from their excess exports to the U.S. In addition to real estate and other investments, U.S. Government securities have become very popular because of the high interest rates that the U.S. Government must now pay, and because of the likely continued appreciation of the dollar.

For some strange reason, we have convinced ourselves we are better off with a strong dollar and cheap imports. Uncle Sam's credit has become so poor that we must sell bonds and notes at high interest rates. It is apparent the U.S. Government cannot raise the money we need locally, while the banking system has invested a fair amount of their available loan money at even higher rates in countries with economic circumstances that are poorer than our own. This makes it convenient for our trading partners to lend money to the U.S. Government rather than buy goods and services in our economy.

Although the high rates make it possible to sell our government securities, the interest costs alone have become a major factor in our current deficit. It is forecast that our annual interest on the accumulated debt will be $150 billion this year, which is at least twice what it would be at interest rates of a few years ago. (See Exhibit I).

The Federal Reserve has worked very diligently to limit inflation. Their technique is to withdraw funds from the banking system by selling securities, which reduces a bank's ability to lend money until required reserves are accumulated, thus, driving up interest rates. It is clear that the Fed's policy of controlling inflation by raising interest and, thus, destroying demand in the economy is in conflict with the Administration's supply-side program designed to stimulate supply. In our semiconductor business we clearly understand that increasing supply lowers prices and stimulates demand. However, we also understand that if the economy is going down because of high interest rates, demand will not respond to increased supply and lower prices.

The Federal Reserve has other means available to control the growth of the money supply. Only once in recent years, back in the late 70's, have they changed the reserve requirement in the banking system by increasing it slightly. Requiring the banks to hold bigger reserves would on the surface attack the problem in the same way, however, if the discount rate was lowered at the same time, we would remove the price control mentality on interest rates, and over time we would have lower interest rates and a healthier banking system with greater reserves and with an interest rate closer to the low inflation rate that was achieved at a very high price in our economy.

We now have the highest real cost of credit since a period of years that started in 1926. At that time the real cost of credit jumped up and stayed up well into the '30s contributing to the economic problems of that era. (See Exhibit J). Our current course is not sustainable without suffering a calamity. We cannot have low inflation with the Federal Government spending beyond its means, which will add to inflation, and at the same time the American consumers also buying from the world market beyond our ability to pay in kind with goods and services.

Adding to the problems of managing the money supply are the huge borrowed cash acquisitions that have become so popular and which contribute nothing to the economy. When a large corporation borrows billions of dollars to pay stockholders of another corporation for an acquisition, the money is redeposited in the system creating a substantial incremental growth in the money supply which must be wrung out some place else. The result is less credit available to smaller businesses or other activity that might expand the economy.

You may have heard that what is needed in this country is a value-added tax which can be removed as a stimulant to export as is done in most other countries. This sounds like a help with the deficit and a simplistic replacement for DISC, which our trading partners say violates the GATT. It is likely that if every country stimulated exports, we would need a hole in the ocean to accept all the goods. This country has recovered from every post-war recession by courageous consumer spending. We will have considerable difficulty recovering from the next recession if we add another tax on the consumer. Yet, the tax loss on imports must be made up. The idea that imports employ a lot of people in the merchandising and distribution of import products is nonsense. The merchandising and distribution would be the same no matter if the product was locally manufactured or imported. The manufacturing contribution to the economy, and tax revenue on that effort is the real shortfall.

In 1971, the U.S. Government concluded there was a serious exchange rate problem and a rising trade deficit, although it only reached $12 billion. At that time it was concluded the solution to overmanaged exchange rates on the part of our trading partners was the imposition of a 10% surcharge on all imports. This worked and produced a rational exchange rate and reasonable trade for quite a few years. Before we consider a tax on consumption, we should talk about a tax on only the imported portion.

There are four additional factors which have contributed significantly to the erosion of the U.S. trade position.

You have heard that a strong U.S. recovery has increased demand for imports while slow economic growth in other major nations has depressed demand for exports. However, recovery in the Far East has matched ours and Europe is not many months behind, and, thus, we won't get much help from these major markets. There is little the U.S. can do about this problem in the rest of the world, although lower U.S. interest rates would keep some foreign capital at home allowing faster expansion of their economies.

The debt problems of LDC's have also depressed demand for U.S. exports, particularly in Latin America. Once again there is little the U.S. can do to alleviate this problem although lower U.S. interest rates would contribute to making it more manageable.

Serious problems in the U.S. business environment vis-a-vis our major trade competitors have also contributed significantly to decreasing our competitiveness and, thus, our trade balance. U.S. Government tax and social policies discourage savings, resulting in a relatively small pool of capital for investment compared with other major nations. Due to high interest rates, uncertainties about future

U.S. economic policy and other factors, the U.S. cost of capital is much higher than for our major foreign competitors. U.S. export control policies represent a growing threat to advanced technology companies operating in the United States. Economic, antitrust, and trade policies vacilate continually creating large uncertainties for U.S. firms. In short, there are major problems in the U.S. business environment that are driving many U.S. firms to expand offshore. Unless these fundamental problems are addressed urgently, this trend will continue.

Finally, foreign government intervention and industrial policies, like targeting, are important factors in depressing U.S. exports and stimulating U.S. imports at the expense of competitive U.S. producers. Such policies protect foreign producers from U.S. competition in their home markets and subsidize and rationalize production and investment. We have already had a significant impact in many industrial sectors ranging from steel to telecommunications. While Japan has been the most successful practitioner, many other countries use similar approaches with varying degrees of success. Japan's Nomura Research Institute has prepared an interesting forecast for the '80s. Communications equipment and semiconductors will achieve giant increases, with electronics replacing automobiles as Japan's principal export in 1984. (Exhibit K).

Japan is pointing its export energies at the U.S. telecommunications industry which has been further laid open to world imports by the grand divestiture experiment, which may stimulate some competition on the service side, but will create the only totally open market in the world for telecommunications imports. The current and growing imbalance in telecommunications with Japan is staggering, and a significant threat to U.S. producers. (See Exhibit L). According to the Commerce Department estimates the imbalance in telephone and telegraph is now 22 to 1 and growing.

Are there solutions to our trade deficit? Can they be addressed separately from the problems of the Federal deficit, monetary and interest policy? I recommend the following:

1. A partial solution to our trade would be a surcharge on all manufactured imports and imported oil until such time as our trade balance and exchange rates reach more rational levels.

2. U.S. monetary and fiscal policy must be modified to help bring interest rates and exchange rates into line with the competitive realities of world trade. If the Council of Economic Advisors' estimate that the dollar is overvalued by 33% is even in the right ballpark, the benefits of such modifications would be enormous.

3. A much more aggressive negotiating effort to open markets of competitor countries which are targeting certain industries or raise the tariff in our sectors . In this context we are favorably impressed with Senator Danforth's new Telecommunications Trade proposal (S. 2618).

4. An improved defense system against injurious imports that result from foreign targeting practices. We strongly support the proposals of Congressman Gibbons and the House Ways and Means Committee in H.R. 4784 to make foreign targeting actionable under the countervailing duty laws.

5. Stronger support for U.S. exporters who face government supported competition in third markets. One example would be to aggressively use newly authorized ExIm Bank and A.I.D. mixed credits to neutralize those offered by major competitors.

The current magnitude and the trend of the U.S. trade deficit is alarming and is causing significant economic problems for our nation. America is spending its way into bankruptcy. Clearly, the GATT system is not working from the American viewpoint. Our trading partners are sending us mammoth quantities of goods and we are unable to sell a reciprocal quantity of either goods or services in return. Imports are strangling one segment after the other of U.S. industry. It is not just a smokestack problem. It is a problem for all segments including high technology. The piecemeal flood of relief requests, such as quotas, tariffs, or voluntary restraints are not solutions.

The leadership in this country must reorder priorities. We have promoted consumption, agriculture and defense. Japan has promoted savings and investment and gradually shifted their target over the last twenty years from textiles, steel and shipbuilding, to automotive, consumer electronics, and now industrial electronics and machine tools. Germany has promoted exports. (See Exhibit M). We need to give the highest priority to improving the competitiveness of U.S. manufacturing and implement the broad range of policies needed to achieving that objective.

If we can successfully bring interest rates more in line with inflation and if exchange rates begin to move towards stronger currencies in those countries with large positive trading balances, the U.S. Government may have continued problem financing the budget deficit, even though there will be a temporary increase in income due to the import surcharge. The U.S. Government will either be faced with payless paydays, or a hard decision to finally reduce spending which is an absolute necessity in any case for a sound economy, and to retain some promise of a reasonable standard of living for our children.

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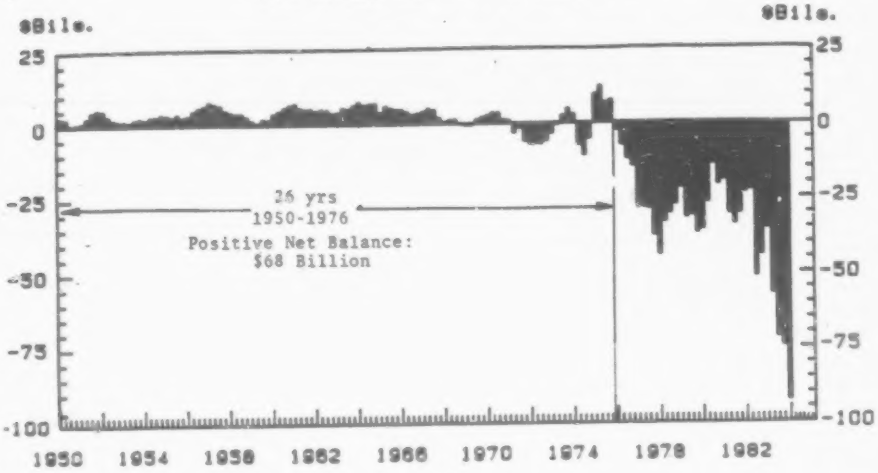
Exhibit A


U.S Trade Balance - Goods

excludes services; includes oil
current dollars

By Quarter, Annualiz
Source: Commerce De

This is the most important problem in the economic sphere, and particularly for the manufacturing industry.

It is an impending disaster.

It, and the Budget Deficit, represent one of the most overwhelming trend reversals in economic history.

The situation is WORSENING rapidly, with every month's new report, and is of utmost URGENCY.

Studies indicate that every billion-dollar addition to the deficit for manufacturing industries is equivalent to 25,000 jobs forfeited for foreign companies.

June 20, 1984

Exhibit 6

Manufacturing Production by Industry,
1960 to 1982

	Annual Percent Growth Trend		
	1960-1982	1975-1982	Difference
Total Manufacturing	3.9	2.5	-1.3
Food and Products	3.2	2.8	-0.4
Tobacco Manufactures	1.3	0.9	-0.4
Textile Mill Products	3.2	0.4	-2.9
Apparel	2.0	-0.4	-2.4
Lumber and Wood Products	2.2	-0.2	-2.4
Furniture and Fixtures	3.8	3.1	-0.6
Paper and Products	3.7	3.5	-0.2
Printing and Publishing	3.3	3.4	0.1
Chemicals	6.4	4.3	-2.1
Petroleum Products	2.7	-0.6	-3.3
Rubber and Plastics	8.2	6.0	-2.3
Leather Products	-1.8	-2.8	-1.0
Stone, Clay, and Glass	3.1	1.3	-1.8
Primary Metals	1.3	-2.5	-3.8
Steel Mill Products	0.6	-4.0	-4.6
Fabricated Metals	3.1	1.1	-2.0
Nonelectrical Machinery	5.0	3.5	-1.6
Electrical Machinery	5.6	5.7	0.1
Transportation Equipment	2.6	0.7	-1.9
Motor Vehicles and Parts	2.8	-2.2	-5.0
Instruments	5.5	3.0	-2.5
Miscellaneous Manufacturing	3.7	1.0	-2.7

The Electronics Industry is in one of only two in our entire nation (see table above), that demonstrated growth gains in Manufacturing in recent years.

Now, for the first time, 1983 shows a negative balance of trade for the entire Electronics Industry. (see table below):

ELECTRONICS INDUSTRY

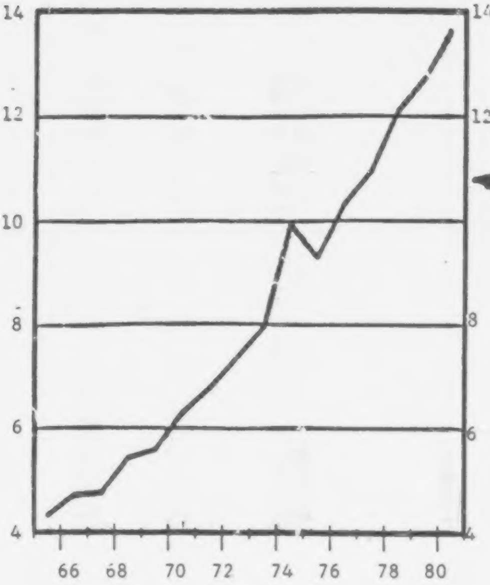
$ bil.

		1980	1981	1982	1983
EXPORTS:	TOTAL	20.1	23.5	24.3	26.7
IMPORTS:	TOTAL	13.3	19.7	21.0	27.6

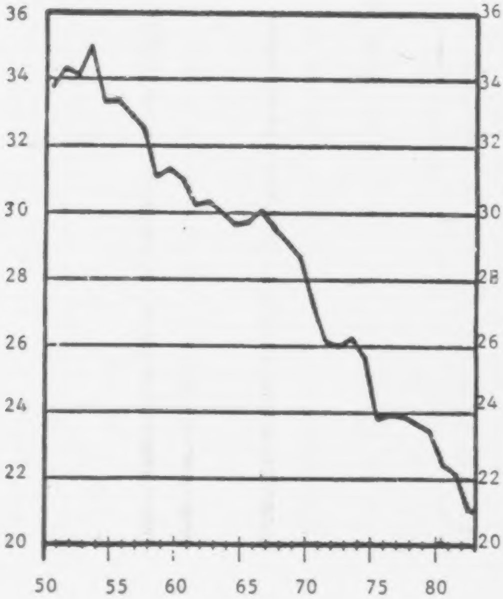
ELECTRONICS BALANCE OF TRADE: ($ BIL.)

	1980	1981	1982	1983
Communications Products	.9	.8	.7	--
Consumer Electronics	-3.7	-6.4	-6.2	-7.8
Electron Tubes	.1	.1	.1	--
Electronic Parts	.3	-.9	-1.2	-1.5
Industrial Products	9.8	10.5	10.5	9.4
Solid State Products	-.3	-.1	-.4	-.6
Other	-.3	-.2	-.2	-.4
TOTAL	6.8	3.8	3.3	-.9

Exhibit C



The Import Penetration Rate in Manufactured Goods, 1965-1980
(Percent)



Manufacturing's Share of Employment, 1950-1982
(Percent)

Exhibit D

Trade With America's 10 Best Customers

(1983, in $ billions)*

	Exports	Imports	Balance	1982 Balance
Canada	38.2	52.5	-14.3	-13.1
Japan	21.9	43.6	-21.7	-19.0
United Kingdom	10.6	12.9	- 2.3	- 2.9
Mexico	9.1	17.0	- 7.9	- 4.0
West Germany	8.7	13.2	- 4.5	- 3.2
Saudi Arabia	7.9	3.8	4.1	1.1
Netherlands	7.8	3.1	4.6	6.0
France	6.0	6.3	- 3.5	1.3
South Korea	5.9	7.6	- 1.7	- 0.6
Belgium and Luxembourg	5.0	2.5	2.5	2.7
And With the EEC	44.3	45.9	- 1.6	3.5

☐ The United States is running a deficit with each of its five best customers and in seven out of the top ten most lucrative country markets.

☐ America's traditional surplus with the European Community has now vanished, leaving us with a 1983 deficit of $1.6 billion.

☐ Exports to the 10 countries listed above accounted for over 60 percent of total U.S. exports in 1983, $121.1 billion out of $200.5 billion.

*Source: U.S. Department of Commerce; imports c.i.f.

Exhibit E

TABLE 4:

U.S. TRADE WITH MAJOR REGIONAL TRADING PARTNERS, 1981-83

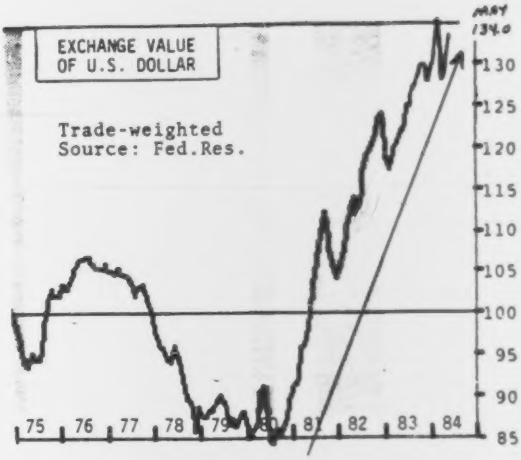
REGION OR COUNTRY	U.S. EXPORTS 1981	1982	1983	Chg. 1981-3	U.S. IMPORTS (C.I.F. BASIS) 1981	1982	1983	Chg. 1981-3	BALANCE 1981	1982	1983	Chg. 1981-83
CANADA	39.6	33.7	38.2	- 1.4	46.8	46.8	52.5	5.7	- 7.2	-13.1	-14.3	- 7.1
EUROPEAN COMM.	52.4	47.9	44.3	- 8.1	43.7	44.5	45.9	2.2	8.7	3.4	- 1.6	-10.3
JAPAN	21.8	21.0	21.9	+ 0.1	39.9	39.9	43.6	3.7	-18.1	-18.9	-21.7	- 3.6
MEXICO	17.8	11.8	9.1	- 8.7	14.0	15.8	17.0	3.0	3.8	- 4.0	7.9	-11.7
EAST ASIA*	19.6	20.2	21.5	1.9	28.0	29.1	35.2	7.2	- 8.4	- 8.9	-13.7	- 5.3
OPEC	20.7	24.9	16.9	- 3.8	51.8	32.7	26.5	-25.3	-31.1	- 7.8	- 9.6	21.5
OTHER LDCc	30.9	25.8	24.8	- 6.1	28.6	26.6	29.3	0.7	2.3	- 0.8	- 4.5	- 6.8
TOTAL TRADE	233.7	212.3	200.5	-33.2	273.4	254.9	269.9	-3.5	-39.7	-42.6	-69.4	-29.7

*Excluding Indonesia - Counted with OPEC

All Figures in Billions of Dollars

Source: Commerce Department, Highlights of U.S. Export & Import Trade

Exhibit F


EXCHANGE VALUE OF U.S. DOLLAR

Trade-weighted
Source: Fed.Res.

The Over-Valuation of the Dollar had its beginnings back in September 1949.

At that time, the U.S. encouraged a major realignment of world currencies:

U.K. devalued	30.5%
W. Germany devalued	20.6%
France devalued	21.5%

Thus, to help restore European prosperity, the U.S. made its Dollar stronger relative to the others.

Every 1% loss of PRICE COMPETITIVENESS because of the dollar has been calculated to WORSEN BALANCE by $2-3 BILLION.

Exhibit G

Table 1:

U.S. TRADE BALANCES AND EXCHANGE RATES WITH JAPAN AND EUROPE

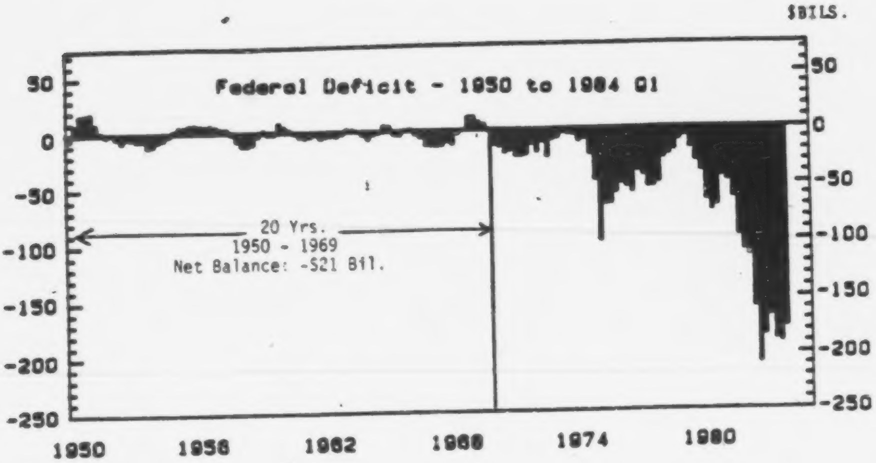
	Trade Balances ($Bil.)			Currency Unit/$U.S.		Chg. in Currency Exchange Rate
	1980	1983	Chg.	Jan. 1, 1981	Jan. 1, 1984	
JAPAN	- 12.2	-21.7	- 9.5	¥ 203	¥ 232	- 14.2%
GERMANY	- 1.3	- 4.5	- 3.2	DM 1.96	DM 2.73	- 39.3
FRANCE	2.0	- 0.3	- 2.3	FF 4.52	FF 8.34	- 84.5
U.K.	2.5	- 2.3	- 4.8	£1 = $2.39	£1 = $1.45	- 64.8
ITALY	0.8	- 1.9	- 2.7	L 931	L 1657	- 78.0
E.C. TOTAL	16.4*	- 1.6	-18.0			

* - Includes Trade with Greece

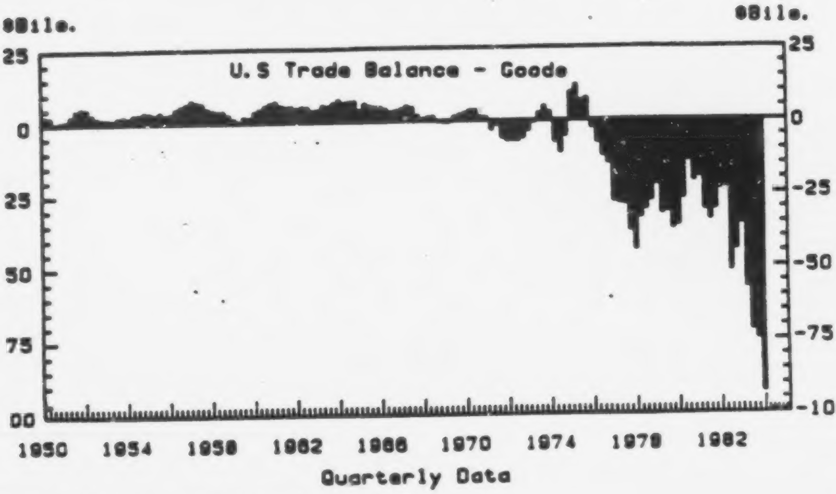
Change in Currency Exchange Rate

Source: International Monetary Fund: International Financial Statistics
Department of Commerce: Highlights of U.S. Export and Import Trade

Exhibit II



If any doubt remains as to the relationship between the Federal Deficit and the Trade Deficit, compare the chart above with the previously shown Trade Deficit chart below.



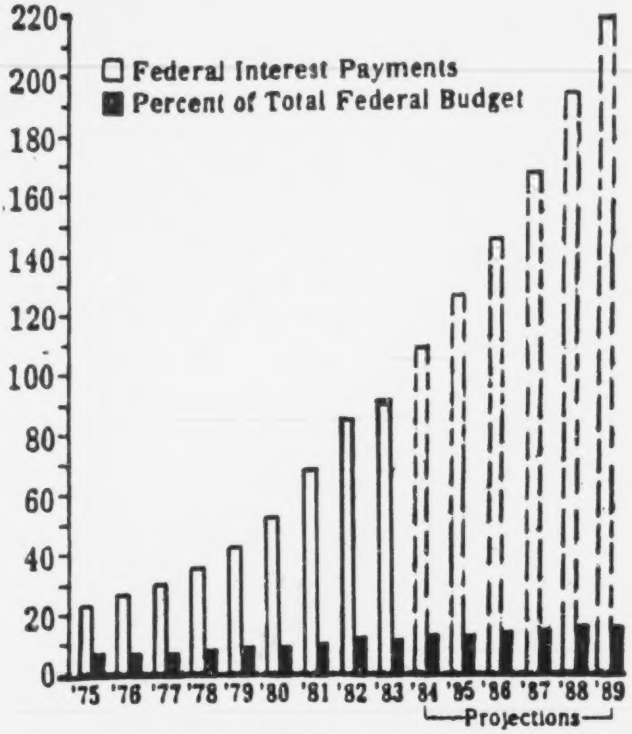
excludes services; includes oil
current dollars

By Quarter, Annualized
Source: Commerce Dept.

Exhibit I

Federal Interest Payments

(In billions of dollars)



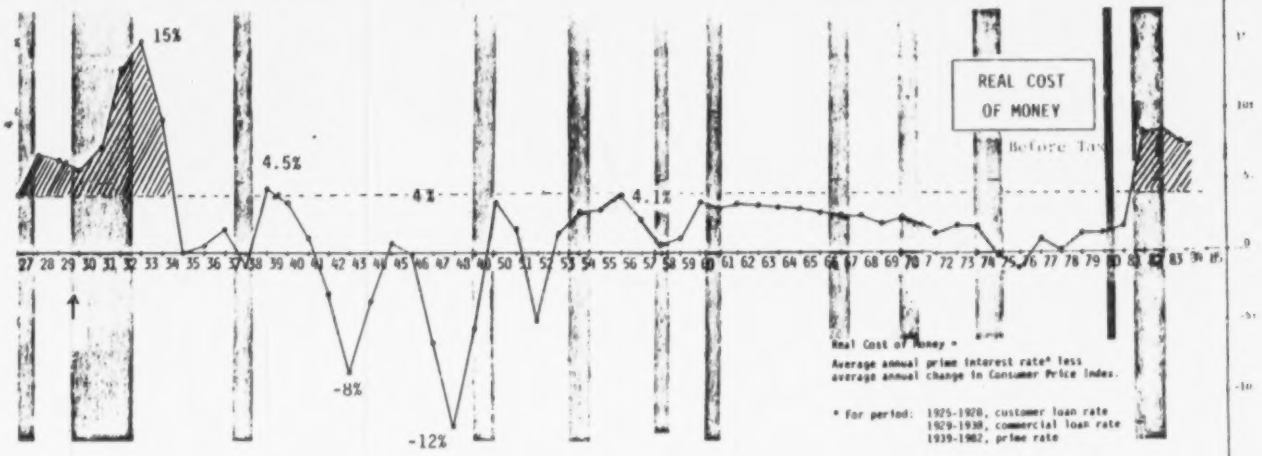
Projections assume no change in current tax and budget law.
Source: Congressional Budget Office

One of the biggest reasons the Budget Deficit and the National Debt keep rising is the high cost of servicing the exploding debt. And this situation worsens every time our very high interest rates climb further.

The cost of servicing the government's debt could be as high as $150 billion over the next year, which now represents 13% of all government spending... and still rising!

This is a crushing burden to taxpayers, especially future generations.

5/23/84 LONG TERM REAL COST OF MONEY TRENDS



Real Cost of Money =

Average annual prime interest rate* less
average annual change in Consumer Price Index.

* For period: 1925-1928, customer loan rate
1929-1938, commercial loan rate
1939-1982, prime rate

Great
Depression
Started at
Arrow.

A danger zone commences
when the Real Cost of
Money rises above 4%.

Exhibit J

Exhibit K

Summary of NOMURA RESEARCH INSTITUTE (NRI) REPORT on the Japanese Electronics Industry

The NRI report is an overview of the Japanese electronics industry in 1983 with forecasts for 1984 and beyond. The report is more descriptive than interpretive and contains few surprises. The principal observations relevant to Motorola are:

- Japan's electronics industry is shifting dynamically from consumer to industrial electronics (Pages 9, 10).*
- Analog communications networks will be replaced with computerized digital communications networks in the 1980's and 1990's (Pages 11-13).
- Japanese expansion into U.S. communications equipment markets will be dramatic in 1984 and beyond (Page 8).
- Spectacular performance in semiconductors is expected to continue in 1984. Shortages of semiconductors since mid-1983 are due to expansion of electronic markets, including car electronics (Pages 8, 9).

PRESENT SITUATION AND NEAR TERM PROSPECTS. Throughout the 1980's, electronics will grow at 12.8%. In 1984, electronics will replace automobiles as Japan's principal export item for the first time (Pages 1-3).

1984 OUTLOOK FOR MAJOR PRODUCTS. Electronics will grow 14% in 1984 (equal to 1983 growth). Leading products will be VTRs, information and communications related products, and semiconductors (Pages 3-9).

- Information Sector: the production value of related computers will reach $9.4 billion in 1984. General purpose computer sales should expand substantially. Personal computer production volume will increase by 45%.
- Communications equipment will take a giant step in 1984 because of liberalization of communication systems. Japanese sales to ATT spin-offs are expected to be "dramatic."
- Semiconductors: Japanese semiconductor manufacturers are making aggressive capital investment. FY 1983 investment was $1.57 billion, a 59% increase over 1982. The effects of 1983 investment will not be felt until after mid-1984 and the shortage of semiconductors is expected to continue until then.

THE ELECTRONICS INDUSTRY AND INFORMATION SOCIETY. Japan has shifted to a predominantly knowledge- and technology-intensive information society. The information industry market is expected to grow to $50 billion in 1987. NTT plans to create an information network system (INS) which calls for a highly sophisticated computerized digital communications system to replace the existing analog communications network in the 1980's and 1990's.

Japan still lags the U.S. in communications and industrial sectors, but is shifting dynamically from consumer to industrial electronics. Japan's competitive strengths based on mass production techniques developed in consumer electronics, will help close the gap in industrial electronics significantly (Pages 9-16).

CORPORATE EARNINGS AND STOCK EVALUATION: Japanese electronics related companies are expected to register impressive growth in FY 1984. In particular, information-telecommunications sector should continue to sustain high earning growth. Semiconductor makers will be burdened with high R & D and capital investments. Profits in telecommunications will depend heavily on appropriate strategies to exploit emerging opportunities in the wake of the ATT break-up.

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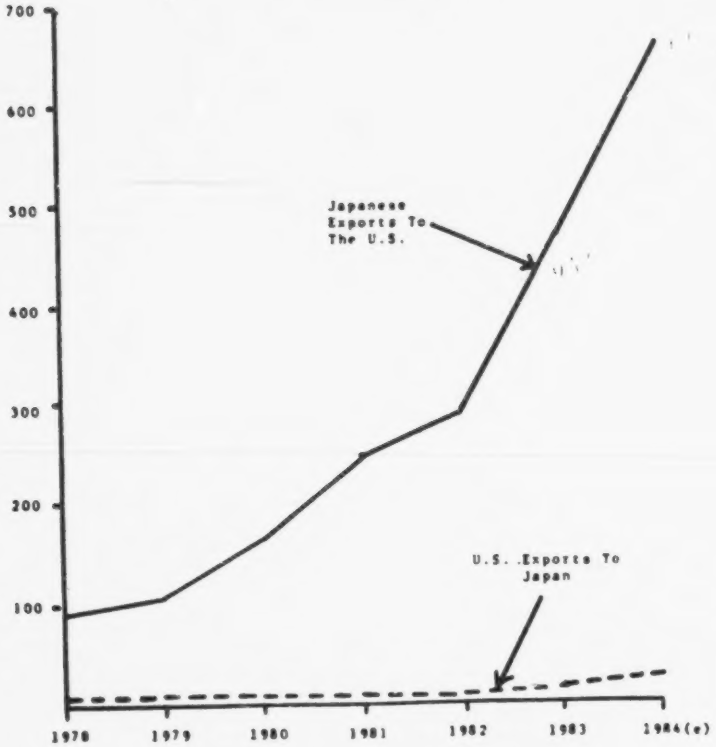
*Page numbers refer to pertinent sections of NRI report.

Exhibit L

Figure 1

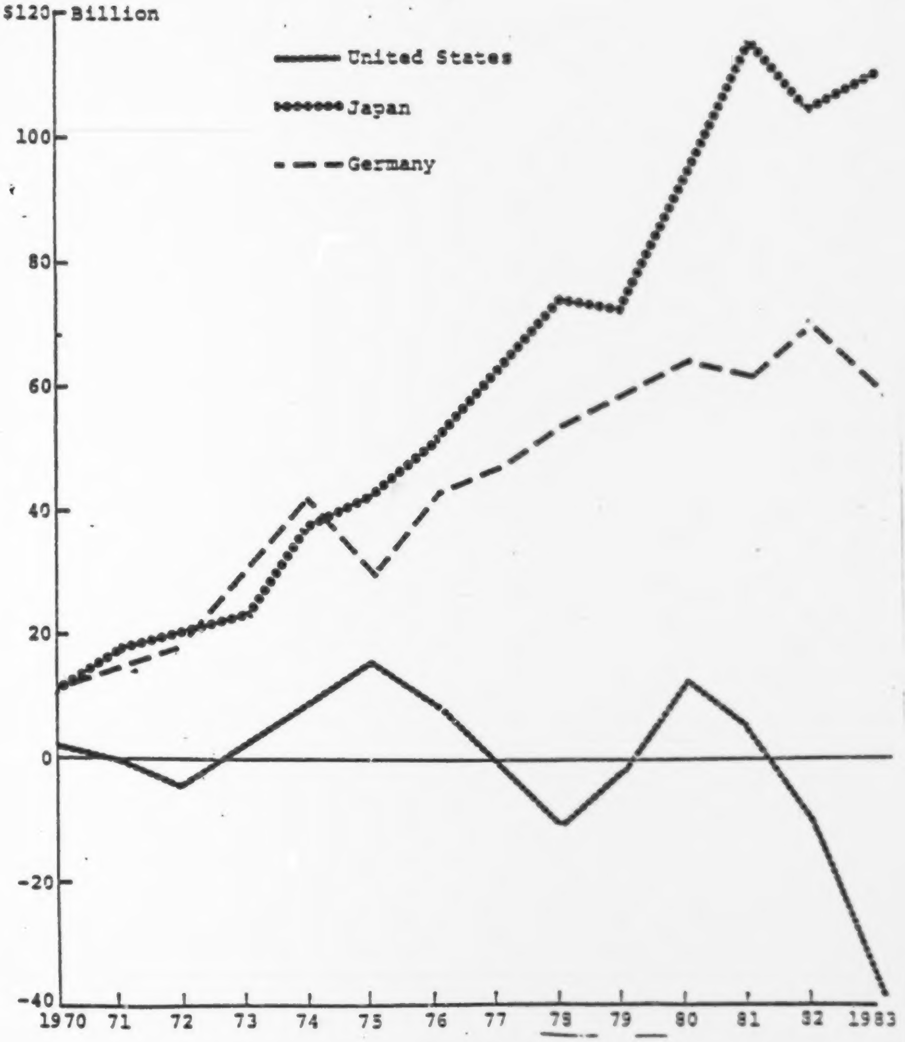
U.S. BILATERAL BALANCE OF TRADE WITH JAPAN
IN TELEPHONE & TELEGRAPH EQUIPMENT (SIC-3661)



Source: U.S. Department of Commerce International Trade Administration, Trade, Development, Science and Electronics Cluster.

Exhibit M

U.S., JAPANESE AND GERMAN MANUFACTURES TRADE BALANCES,
1970 - 1983



Imports c.i.f., except U.S., 1971-74.

Source: U.S. Department of Commerce, International Economic Indicato

Senator **Danforth**. Your position is that it is time to think big, and it's time to think quickly. Do you see any problems with the surcharge?

Mr. **Mitchell**. Well, I think you will immediately hear from a variety of people that this is going to raise inflation in this country, cost the consumer, et cetera.

Senator **Danforth**. There is no doubt about that, is there?

Mr. **Mitchell**. I think that there is a great question as to how much of that surcharge would be passed onto the consumer. It seems to me that some of our trading partners would absorb some of that. Clearly, companies like ourself would have to pay some of that surcharge. It isn't clear that we would be able to pass all of that onto the market. Market price is still determined by the market in the United States.

There would be, clearly, some impact on the cost of goods and services that are imported. There would, however, be a substantial relief in the Federal budget deficit, interest rates would move down and it seems to me that there could be a substantial decrease in the cost of housing as it relates to interest rates, and automobiles and other things that relate to interest rates.

Senator **Danforth**. There would be retaliation?

Mr. **Mitchell**. Well, it wasn't clear to me that there was much retaliation last time. There was tremendous jawboning, and then the exchange rates started to move. Finally when trade became rational, the surcharge was removed. And I think it ought to be stated as a temporary measure because we have a tremendous, but hopefully a temporary problem.

But when we hear talk about retaliation, it is difficult to retaliate if you are selling the other fellow a tremendous quantity of goods and buying very little in return. It's very difficult if you are already buying only what you really need.

Senator **Danforth**. Some people believe that we made a mistake a couple of decades ago or so when we placed our emphasis and that of our trading partners on trying to lower tariffs. And we did. There have been significant reductions in tariffs. But in lieu of tariffs, various quotas and nontariff barriers have arisen. In addition to lowering tariffs, we have put in place a most-favored-nation system where everybody is to be accorded the same benefits as everybody else. Some people have suggested that this has been a fundamental mistake for the United States, and that a tariff system is fairer. It's much more visible; economic consequences of tariffs are much more apparent than economic consequences of quotas, therefore, they are there for policymakers to look at. And the suggestion has been made that we should return to the tariff system in international trade.

Would you see a surcharge as being the first step in that direction?

Mr. **Mitchell**. Well, I would hope not. Frankly, as an industry, we keep talking about reducing tariffs and opening up borders, but when the system doesn't work, it's time to make some changes. For a long time we have faced a 17-percent duty on semiconductors going into Europe. The result is we have put manufacturing capacity in Europe to serve the market. And the tariff remains. It is still difficult to ship into Europe. Semiconductor capability for much of the world is thriving outside of Europe, but Europe is going to be well served by factories located in Europe because of that particular tariff.

Is it a good idea to put that in on a permanent basis? We think not. We probably would have a good part of those factories there to serve the market, be close to the market, and the customer's unique need in any case, but there is a big financial incentive to do it.

Frankly, with the incentives in this country due to the overpriced dollar, we could move factories out of this country and export back into it from overseas. And that would be a tragedy if that trend continues.

Permanent tariffs are obviously something we would not like to see. We think a surcharge that would get the exchange rates back to some place reasonable is desirable. The exchange rates of 1977, 1978 were liveable. We had a yen at 180 rather than 238. Then we had a liveable situation even with the Japanese.

Senator DANFORTH. Senator Chafee.

Senator CHAFEE. I don't have any questions. I appreciate your testimony.

Senator DANFORTH. I appreciate your support for S. 2618, the telecommunications bill, something we had a hearing on 2 days ago, I guess. And this is a subject which I believe deserves attention.

There is no doubt in your mind, I take it, that with the divestiture of AT&T the effect has been the same as the unilateral trade concession?

Mr. MITCHELL. Yes. There is no question but what the U.S. telecommunications market is the only open market in the world. The other markets have had alignments between the State-owned operating companies and the one or two or three preferred suppliers. This is almost without exception. The United States is not only the most open market, but was opened further by divestiture, and the regional companies have been put in competition with their former supplier, AT&T Technologies in the premise equipment market. Of course, the only source of competitive gear is outside the old Western Electric sources. Much of that, of course, is going to come in from overseas, and it is.

Senator DANFORTH. Thank you very much, Mr. Mitchell.

Finally we have a panel: Robert Z. Lawrence, senior fellow, The Brookings Institution; and Gary C. Hufbauer, senior fellow at the Institute for International Economics.

STATEMENT OF ROBERT Z. LAWRENCE, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Senator DANFORTH. Mr. Lawrence.

Mr. LAWRENCE. Thank you very much. I believe that the subject of this hearing is extremely important. The U.S. Congress, which shares responsibility with the President for making trade policy, has a crucial role to play in alleviating the sources of current protectionist pressures.

But I also would like to emphasize that to do so requires understanding that problems due to inappropriate monetary and fiscal policies cannot be solved with structural policies such as tariffs and quotas. In my testimony I suggest that the U.S. current deficit is principally a response to U.S. fiscal policies. It is neither the result of an aberration in the exchange rate system, nor a sudden surge in unfair trade practices. To the contrary, the emergence of the large current account deficit, driven mainly by changes in the relative prices of U.S. products, is evidence that the exchange rates respond to bring international trade flows in line with changes in national spending patterns.

Tariffs or quotas on particular products will harm consumers and simply increase the competitive pressures on other industries. They will not have much effect on the size of the current account deficit. Tariffs on all U.S. imports are likely to be offset by shifts in the exchange rate and simply place more of the deficit burden onto U.S. exports. Because of its fiscal policy, this nation has reduced its savings rate. To maintain its spending pattern, it has to become increasingly indebted to the rest of the world. To reduce borrowing from abroad, fiscal policy must be changed.

In my testimony I suggest that instead of thinking of the trade balance as the difference between exports and imports, it's more instructive to think of the trade balance as the difference between national savings and national investment. Basically, a country that has a large current account deficit is investing more than it is saving.

And, therefore, I think there is an inherent link between this Nation's decision to borrow from the rest of the world and the fact that we now have a trade deficit. Indeed, if you go through the logic it's rather self-evident. It is necessary to assume that an economy is at full employment. But after all, that's what the structural deficit problem is about. It's the deficit that we are going to run at full employment.

If this country has a Federal deficit, as is projected, of 5½ percent of GNP [State and local governments have a surplus of 1.5], then what we have done compared to our previous record is to dissave as a nation to the tune of about 4-percentage points of the gross national product.

The question is what will finance that 4 percent. And as an identity—and by definition true—that there are two ways we can do that. One is to reduce our investment or raise our savings. And the second way is to borrow from abroad.

We would hope that as a nation we would not lower our national investment rates. And, indeed, the evidence suggests that we don't appear to be doing that. There is also evidence to suggest that the private savings rate historically has been relatively constant, and the prospects are that it will remain so in the future. Therefore, we will be financing a lot of our fiscal deficit by the current account deficit.

And I suggest that given these national spending policies, which promote the international competitiveness of one type of product in our economy, will simply increase the competitive difficulties of others. Thus, for example, protecting industries like steel and textiles will, by keeping the dollar relatively strong, hurt sectors such as computers and aircraft.

The second part of the testimony—I suggest that it's important to look at the historical record in order to evaluate many of the arguments that we are now hearing today about the questions relating to the need for new forms, dramatically new forms, of structural policies in our manufacturing sector.

Some of these arguments that we hear allege that in the current international trading environment, which is marked by heavy competitive pressures from the Japanese, from the newly industrializing countries, and by growing protectionism abroad, that American manufacturers cannot compete.

What I show is that in the course of the 1970's, a time when these elements were already present, the empirical evidence contradicts the arguments that American manufacturing cannot compete. In fact, over that period our manufacturing trade balance increased, the jobs created in our manufacturing sector through our increased exports outweighed those due to the loss of imports. And, therefore, when we want to look for an explanation for the current trade performance, we need look no further than what has happened to the prices of American products compared to those of our competitors.

I present econometric evidence that shows that if you stop a model in 1980 and you go out of sample, plugging in the changes in prices that have occurred over the period to our products, it turns out that you can predict very accurately what has happened to the flows of our manufactured exports and to our manufactured imports. There are other factors in the environment—obviously the developing country situation—that are important.

But I emphasize that it's the prices of our products that have had the major effect. And, therefore, in order to deal with this problem, I think we have to take measures to deal with our fiscal deficit. And I think there is no substitute.

And, therefore, I conclude that we need to do more than simply provide a down payment to reduce the fiscal deficit. We need an installment plan that will provide clear and credible signals to financial markets that the Nation has a strategy for restoring national patterns to a sustainable level.

Senator Danforth. Thank you, sir.

[The prepared statement of Mr. Lawrence follows:]

Statement of Robert Z. Lawrence*
Senior Fellow, The Brookings Institution
before the
Subcommittee on International Trade
Committee on Finance
June 28, 1984

Over the past three years, there has been an astounding decline in the U.S. balance of trade in goods and services. The current account has swung from a surplus of $0.4 billion in 1980 to a $40.8 billion deficit in 1983. The balance of trade has declined $33 billion over the same period, and the balance of trade in manufactured goods has fallen by $42 billion. While most observers agree that the recent trade slump is related to the strength of the dollar, as well as the recession and debt problems abroad, for some these trade problems simply highligh a more deeply rooted erosion in U.S. competitiveness over the postwar period.

There is a growing danger that the free trade direction of U.S. postwar trade policy could be reversed. The Reagan administration has faced protectionist pressures probably greater than those of any administration in the postwar period. The mix of macroeconomic policies between 1980 and 1983 strengthened the dollar bringing about a large trade deficit at a time of high unemployment. Given these economic conditions, the internal procedures for mitigating the adverse effects of trade (e.g., via safeguard actions which grant temporary protection) have become strained. Multilateral trade negotiations serve as a useful counter to domestic pleas for assistance from unfair trade practices and allow the President to keep the trade policy initiative. But the worldwide recessionary conditions in 1981 and 1982 (and some clumsy international diplomacy) have prevented initiating a new mulitilateral trade round. Because it has reduced the scope of the Trade Adjustment Assistance programs, the administration has been without the option of using this program to diffuse requests for aid — a tactic used successfully by Presidents Gerald Ford and Jimmy Carter, especially in election years.[1] Thus despite its ideological commitment to free trade, the Reagan administration has been forced to grant protection: It has raised duties on imported motorcycles and placed quotas and duties on imports of specialty steel in response to findings by the International Trade Commission. And, even without such findings, it has sanctioned a tightening of restrictions on textiles trade, reintroduced quotas on sugar, and obtained voluntary export quotas on Japanese automobiles. Instead of applying the appropriate remedy of countervailing duties on dumped European steel, the administration has negotiated quota arrangements with the European Community.

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*The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its officers, trustees, or other staff members.

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[1] See Gary Clyde Hufbauer and Howard Rosen, "Managing Comparative Disadvantage," mimeo, December 1983.

The postwar progress toward freer U.S. trade is now threatened. On the one hand stands an administration, ideologically committed to free trade, but forced by pragmatic considerations to protect major industries with quotas. And on the other hand, a host of alternative proposals — some nominally committed to rationalizing and eventually reducing protection — which would effectively ease the conditions on which particular sectors are given protection. The United States Congress, which shares responsibility with the President for making trade policy, has a crucial role to play in alleviating the sources of these protectionist pressures. To do so requires understanding that problems due to inappropriate monetary and fiscal policies cannot be solved with structural policies such as tariffs and quotas.

In this testimony, therefore, before discussing policy, I would like to briefly set forward some conceptual points about the trade balance and then provide an explanation for recent trade balance behavior.

I will suggest that the U.S. current account deficit is principally a response to U.S. fiscal policies. It is neither the result of an aberration in the exchange rate system nor of a sudden surge in unfair trade practices. To the contrary, the emergence of the large current account deficit, driven mainly by changes in the relative prices of U.S. products, is evidence that the exchange rate responds to bring international trade flows in line with changes in national spending patterns. Tariffs or quotas on particular products will harm consumers and simply increase the competitive pressures on other industries. They will not have much effect on the size of the current account deficit. Tariffs on all U.S. imports, are likely to be offset by shifts in the exchange rate and simply shift more of the deficit burden onto U.S. exporters. Because of its fiscal policy, this nation has reduced its savings rate. To maintain its spending patterns it has to become increasingly indebted to the rest of the world. To reduce borrowing from abroad, fiscal policy must be changed.

Thinking about the Trade Balance

The balance of trade in goods and services -- the current account — is defined as the difference between exports of goods and services and imports of goods and services.

It is usually argued that any measure which increases exports (e.g., export financing) or which reduces imports (e.g., a tariff) will increase the trade balance. However, this reasoning fails to consider the economy-wide effects of such measures. Assume, for the sake of argument, that the economy is at full employment producing all the goods and services possible. Increasing exports leaves fewer goods available at home. If exports increase, domestic residents must either lower their spending or buy more from foreigners. Since a dollar earned from selling exports is likely to be spent in the same way as a dollar earned from selling other goods, policies which promote exports will be unlikely to affect spending patterns. In the absence of a change in total domestic spending, then, any policy which increases exports will also increase imports.[2]

This example points to the important connection between spending patterns and the current account. Indeed the current account is by definition equal to the difference between what the nation produces (its national income and output) and what it spends.[3] If the current account is in surplus, for example, national production exceeds national expenditure of goods and services -- in other words, we export more than we import.

Recognizing that the current account level reflects national spending behavior has crucial policy implications. First, it suggests that current account deficits are by themselves neither good nor bad. Just as there are times when an individual appropriately spends more than his income, such as childhood, studenthood, retirement or a sudden emergency, so there are times when an economy appropriately runs current account deficits. For example, a developing economy, in which domestic savings are too meagre to meet the available investment opportunities, borrows from the rest of the world absorbing resources through its current account deficit. And a deficit (or surplus) in the current account which is due simply to business cycle fluctuations in one country need not indicate that fundamental adjustment is required. In the case of the United States at present therefore, this view suggests considering whether our spending opportunities have suddenly increased beyond our earning capabilities and whether or not we should borrow to meet current spending needs.

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[2] The same reasoning operates if domestic residents switch from buying domestic goods to imports. At full employment this implies that the domestic goods they no longer buy are available for export.

[3] From the national income accounts:
$Y = C + I + X - M$
where Y equals income, C equals private and government consumption spending, I equals investment, X equals exports and M equals imports,
or $Y - C - I = X - M$
i.e., the current account $(X - M)$ equals the difference between income and spending on consumption plus investment.
and $S - I = X - M$
i.e. the current account equals the difference between domestic savings $(S = Y - C)$ and domestic investment.

Second, this view points to the links between policies which change national spending patterns and the current account.

If government spending is raised in a fully employed economy, domestic residents will either charge their spending behavior and purchase fewer domestic goods and services, or they will purchase more imported goods and services. There is therefore a direct link between the government budget deficit and the trade deficit. Assume that the government raised its deficit at full employment with no change in the spending levels of domestic residents. In the short run, there would probably be an excess demand for domestic goods. Eventually, however, their prices would rise above those of imports until domestic residents were willing to purchase imports instead. Thus the increase in the government deficit at full employment would be associated with a rise in the relative price of domestic goods. With changes in tax and spending policies, the United States government has since 1981 raised the federal deficit the economy will run in 1989 to an estimated 5.0 percent.[4] In the absence of a decline in private spending on consumption or investment at full employment, this government deficit will have to be financed from abroad. U.S. national spending will rise relative to U.S. incomes and via the trade deficit the increased American demand for goods will be met from abroad. A relative rise in the prices of U.S. products, manifested by a stronger dollar could in part facilitate this process. Thus there is a causal link between the government deficit and the current account deficit that the U.S. will sustain at full employment.

This view of the current account as determined by national spending patterns is crucial for evaluating several other problems facing U.S. trade policy. Some see the current trade deficit as alarming. To improve the deficit, they advocate adopting protective measures such as tariffs and quotas on particular sectors. However, just as squeezing a balloon will redistribute, but not reduce the total amount of air in the balloon, so, in the absence of a shift in national spending patterns, imposing tariffs and quotas will only change the composition of trade, but not affect the overall current account deficit. Since the current account deficit reflects an aggregate excess of national spending over national income, spending less on one type of foreign good will simply mean spending more on others. Less imports of one good, will therefore mean a combination of more imports of other goods, and less exports. The exchange rate is again one mechanism by which this process operates. A quota would in the short run reduce imports, but it would also increase the current account, strengthen the currency, and thereby make it more difficult for other sectors in the economy to compete internationally.

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[4] For a detailed analysis, see Alice M. Rivlin, ed., Economic Choices (Brookings Institution, 1984), chap. 2.

Given national spending patterns, policies which promote the international competitiveness of one type of product in an economy, will increase the competitive difficulties of others. Thus for example, protecting industries like steel and textiles will, by keeping the dollar strong, hurt sectors such as computers and aircraft.

This view of the current account helps to clarify the policy debate between the United States and Japan. Many beleive protectionist measures are an important source of the difficulties foreigners face in selling in Japanese markets. They advocate pressuring Japan to increase imports. This strategy has merit, but also has some important implications. Japanese current account surpluses ultimately reflect Japanese spending patterns. Given any level of Japanese income, production, and particular spending patterns, increasing Japanese imports will reduce domestic spending on Japanese products. In the short run therefore, there will be an excess supply of Japanese goods. In order to sell them abroad, Japanese manufacturers may have to lower their prices. Thus, more Japanese exports will accompany the rise in

Japanese imports. (The exchange rate may play a role in stimulating greater exports.) If Japan opens its markets, either the world will have to absorb more Japanese exports, or the Japanese will have to change their spending patterns. Increased Japanese demand for imports may mean a weaker yen and thus increased Japanese exports. In concrete terms therefore, a policy of opening the Japanese market will probably mean greater competitive pressures for industries such as automobile and steel in which the Japanese are highly competitive in international markets. Conversely, placing quotas on Japanese exports to the United States of these products over the long run will mean more Japanese exports of other goods.

This approach to the current account also suggests an explanation for the relative weakness of the Japanese yen: a combination of a high national savings rate and a large dependence on foreign oil. When the price of imported oil rose rapily, Japan had two choices: export more to pay for higher costs of imports, or borrow more. Given their spending patterns they did not borrow and thus spent more on oil and less on domestic goods. This choice created an excess supply of Japanese goods, as well as an excess of yen on the market. To induce foreigners to by these goods, prices had to be lower -- a shift accomplished in part by the declining value of the yen.

In summary, therefore, recognizing that current account deficits reflect national spending patterns has important policy implications. If particular deficits are seen as undesireable, shifts in policies which affect national spending patterns should be used. To lower a current account deficit, government revenues should be raised, government spending reduced and/or private consumption and/or investment lowered. In the absence of a change in spending patterns more imports will eventually lead to more exports or vice-versa. Sectoral policies such as tariffs, quotas and selective export credits will change the composition of trade and terms of trade, but over the long run, since they are unlikely to shift national spending patterns, they will leave the overall trade balance in goods and services unaffected.[5] In an economy with unemployment, selective policies could raise income in the short run. However, in the short run the economy is typically constrained by the amount of monetary growth the Federal Reserve is prepared to allow. Thus again more production of one product will mean less of another.

The Evidence

Over the long run, the components of the current account — the trade balance in goods and services — have strong trends (see figure 1). The United States has become a mature creditor nation with a declining balance on merchandise trade and a growing surplus from investment income and other services and remittances. In the 1950s and the first half of the 1960s, drawn by the attractiveness of foreign investment opportunities, capital flowed out of the United States. The counterpart to this outflow was a surplus in the U.S. current account including merchandise trade. By the early 1970s, however, in the aggregate, Americans ceased investing abroad, and the current account moved to a rough balance. This overall balance resulted from two offsetting developments: On the one hand, the balance on merchandise trade trade declined. On the other hand, the balance on the services account increased, boosted in particular by a rise in revenue from overseas investment. As illustrated in figure 2, the overall decline in the balance of trade reflected the dominant impact of the deficit in U.S. trade in fuels and lubricants. The United States became a major oil importer at a time of rising oil prices. The trade deficit slump in the 1970s concealed increasing U.S. trade balances in manufactured goods and food, feed and beverages.

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[5] The discussion thus far has concentrated on an economy at full employment. But its implications are valid for an economy at any constant employment level. Policies such as tariffs and quotas are implemented for long periods of time. Acordingly this is an appropriate framework for evaluating most of their effects.

In the 1980s these patterns have changed quite dramatically. The current account has shifted into a sizeable deficit (see figure 2). There has been a marked improvement in the trade balance in crude materials and fuels but this has been offset by declining performance in manufactured goods and foods, feed, and beverages. There was also a small decline in in the balance on investment income.

The performance of the trade balances in services, fuels, and agricultural products are easily understood. The services balance is dominated by returns in the U.S. net investment position. The fuels balance recently reflects improved conservation in U.S. energy consumption and a weak world oil market, while agricultural trade balances are mainly influenced by declining grain prices due to oversupply and a depressed world economy. The contentious issues, however, occur mainly in explaining U.S. manufactured goods trade performance.

Explaining Manufactured Goods Trade

International trade in manufacturing is now widely viewed as a major reason for the declining share of manufacturing in U.S. employment. Many attribute this development not to an inevitable shift in U.S. patterns of specialization because of changes in relative endowments of factors of production or the international diffusion of technology but rather to the impact of foreign government policies. By protecting the home market and aggressively stimulating export sectors, U.S. competitors have created comparative advantages for their industries in manufacturing. Unless the United States responds with protectionist policies of its own, it will eventually become a nation specialized in farming and services — a nation of hamburger stands.

In my recently published study, Can America Compete?, I have examined the performance of the U.S. manufacturing in both the 1970s and the 1980s.[6] My findings call these allegations into question.

The Adjustment Process at Work: U.S. Manufactured Goods Trade in the 1970s

Between 1970 and 1980, the U.S. trade balance in manufactured goods increased from 3.437 billion to 18.8 billion or from 0.3 percent of GNP to 0.7 percent of GNP. The volume of U.S. manufactured goods exports increased by 101.2 percent, while the volume of imports increased 72.0 percent. Over this period, I have estimated that the jobs in U.S. manufacturing due to exports were virtually identical to the jobs that might have been gained had manufactured imports been replaced by U.S. products.[7] Between 1973 and 1980, trade had a markedly positive impact on manufacturing employment adding about 280,000 jobs in manufacturing. These employment gains were widely diffused; jobs due to increased exports outweighed those lost to higher imports in 40 out of 52 U.S. manufacturing industries. Over this period, the declining trend in the U.S. share of world manufactured goods exports was arrested. The share was 16.4 percent in 1973, 16.4 percent in 1980 (and 18.1 percent in 1981). Thus over the 1970s, U.S. manufacturers were able to compete relatively successfully in international trade.

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6. Robert Z. Lawrence, Can America Compete? (Brookings Institution, 1984).

7. See Robert Z. Lawrence, "Is Trade Deindustrializing America: A Medium Term Perspective," Brookings Papers on Economic Activity, 1983:1.

In the period 1973 to 1980, the elements in the environment which are alleged to prevent U.S. manufacturing from competing were already present: U.S. manufacturers confronted surging competition from Japan and Newly Industrializing Nations and government industrial and protectionist policies were already widely in use.

The evidence from the 1970s calls into question allegations that in the current international trading environment U.S. manufacturing cannot compete are inaccurate.

In the 1970s, the United States did become a major importer of oil at a time of rising oil prices. Many observers believe that the U.S. also experienced a decline in its competitiveness as its technological lead was eroded. Since the U.S. did not change its spending patterns very dramatically, an improvement in the relative prices of U.S. manufactured products was required to generate sufficient exports to keep the overall current account in rough balance. The decline in the real exchange rate associated with several dollar devaluations in the 1970s, was an effective mechanism for keeping manufactured goods trade at a level required for overall equilbrium in the external accounts.

From 1973 to 1980, U.S. productivity growth in manufacturing was slower than in most other industrial countries. But in the 1970s, slower rises in U.S. wages and profits and the depreciation of the dollar more than offset the slower growth in U.S. manufacturing productivity.

All other things being equal, the slower rise in U.S. export prices as compared with U.S. import prices (associated with the devaluations), reduced U.S. welfare. In this sense in the 1970s, the U.S. lost competitiveness: to keep the current account at the same share of GNP, a lower exchange rate was required. Paying for a given volume of imports with more U.S. products resulted in an erosion of U.S. living standards but it did not erode the U.S. industrial base. To the contrary, it required a rise in manufactured inputs. It would have been preferable, if the the U.S. had not experienced this deterioration in its terms of trade in the 1970s. But it should be noted however that, had the U.S. sought to avoid these devaluations by using subsidies tariffs or other selective industrial policies, it would also have lowered its living standards. For trade protection and government subsidies also impose costs on taxpayers and consumers. Thus the real issue facing U.S. trade policy, is not between matching foreign industrial policies and deindustrialzation, but rather between relying on market forces operating through changes in the real exchange rate to maintain equilibrium or attempting to do so by government intervention.

Manufactured Goods Trade from 1980 to 1983

For many, the structural problems facing U.S. manufacturing are a relatively new phenomenon not captured by an analysis of the 1970s. And indeed, between 1980 and 1983, there was a preciptious erosion in the trade balance in U.S. manufacturing. Over this period, the volume of manufactured imports increased 25.9 percent, while export volumes plummetted 22.6 percent. But how important were relative price deterioration in U.S. competitiveness associated with the rise in the dollar and the overall recession in the world economy as compared with new elements indicating structural change?

As I indicate in my study, when econometric equations explaining U.S. manufactured goods trade are estimated through 1980 and used to forecast trade volumes through 1983, they predict U.S. trade flows rather accurately.[8] Thus it appears that trade flows have retained their previous historical relationships to the variables in the equations, and that the underlying system has not undergone a substantial structural change in the period under consideration.

The equations can also be used to indicate the relative contribution of changes in relative prices and economic activity in the United States and in the rest of the world. Relative price effects have played the dominant role: From the first half of 1980 to the first half of 1983, the export equation indicates that the change in U.S. relative price competitiveness induced a 32.8 percent fall in U.S. export volumes. Trend factors added about 17.5 percent to export volumes. But the global recession and decline in world trade depressed exports by 14.1 percent. The equations suggest that imports were raised by 16.7 percent because of the relative increase in U.S. prices, and by 17.5 percent because of trend factors; imports were reduced by 6.8 percent because of the drop in the ratio of actual to potential GNP during the U.S. recession. The actual and forecast changes for trade flows in 1980-83 are shown below.[9]

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[8] For a more complete discussion see Lawrence, Can America Compete?, chap. 3.

	Actual change	Forecast Change due to			
		Prices	Activity	Trend	Error
Exports:	-30.3	-32.8	-14.1	17.5	0.9
Imports:	25.8	16.7	-6.8	17.5	-1.65

The equations also suggest a somber prognosis: only about three-fourths of the long-run effect of the erosion in U.S. price competitiveness from 1980 to 1983 has been felt by the second half of 1983. In the absence of an improvement in U.S. price competitiveness over its levels in the second half of 1983, the equations predict an additional drop of 21 percent in manufactured exports, and a rise of 5.4 percent in imports in 1984 and 1985 due to 1980-83 changes in relative price factors.

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[9] Actual changes are from the first half of 1980 to the first and second halves of 1983 for exports and imports, respectively.

In Summary. The decline in the manufactured goods trade balance from 1980 to 1983 was not the result of a sudden erosion in U.S. international competitiveness brought about by foreign industrial and trade policies. It is predictable given previous trends and current levels of economic activity and relative prices. Changes in the real exchange rate have been effective in moving the U.S. current account toward equilibrium, as determined by expenditure patterns. In 1970 and in 1980 the current account was a similar percentage of GNP. This stability was accomplished in part by growth in the manufactured goods trade balance because of the real devaluation of the dollar. In the 1980s the shift in the United States toward large full-employment government deficits unmatched by lower private consumption entails a current account deficit as the savings of foreigners help finance the U.S. government borrowing. This is accomplished in part by a decline in the manufactured goods trade balance achieved through real appreciation. If these trade flows are viewed as undesirable, policies to lower full-employment government deficits should be considered. In the absence of a substantial decline in the dollar in 1984, price pressure will continue to cut off foreign markets for domestic producers in 1984 and 1985.

Policies

In the conceptual discussion I have emphasized the inappropriateness of reducing the U.S. trade deficit by protecting particular U.S. industries. Given spending patterns in the United

States, measures which reduce imports of one product will eventually reduce exports and or increase imports of other products. To reduce the deficit in goods and services, it is necessary to consider policies which will change U.S. spending patterns.

The U.S. could alter its macroeconomic policies which, by shifting the real exchange rate, would make foreign markets more attractive to U.S. firms. U.S. macroeconomic policies and those of other industrial countries have exacerbated the structural adjustment problems facing the world economy. Since inflation restraint remains a major policy objective, it is likely that the U.S. will pursue relatively restrained monetary and fiscal policy over the next few years. But the mix of fiscal and monetary policies used to achieve any given level of aggregate demand merits attention for it will have an important influence on international competitiveness. The budget deficit and the current account deficit are linked. If the economy is at full employment, and the government seeks to increase its consumption, either the private sector will have to consume less, or the goods will have to be obtained from abroad. As the U.S. government borrows, this raises interest rates. These higher interest rates induce capital inflows, which strengthen the dollar. As a result U.S. products become more expensive, and this reduces the trade balance. Given private spending behavior, an increase in the government deficit thus leads to an increase in the trade deficit.

A preferable strategy would reduce U.S. interest rates through tighter long-run fiscal policy (this would require lower spending especially on defense and higher taxes) in return for a relatively easier monetary policy.[10] These policies would entail lower interest rates, reduce capital inflows and, since a smaller government deficit implies less need to absorb foreign resources, result in a weaker dollar. An improvement in international competitiveness obtained in this manner would entail more stimulus to the economy from the foreign sector and less from the government sector. It would channel investment towards all U.S. firms competing in foreign trade. The policy would be even more effective if coordinated with moves by the Japanese and others to change their policy mix toward a looser fiscal and somewhat tighter monetary policies.

Although I have concentrated, in this testimony, on macroeconomic policy questions, I do not mean to leave the impression that U.S. trade policies leave no room for improvement. The United States has always had such policies; the key issue is not whether we should have them, but rather how they can be made more effective. In the trade area there is a pressing need for an improved program for trade adjustment assistance, reform of international procedures on escape clause actions and a new multilateral negotiation to deal with non-tariff barriers.

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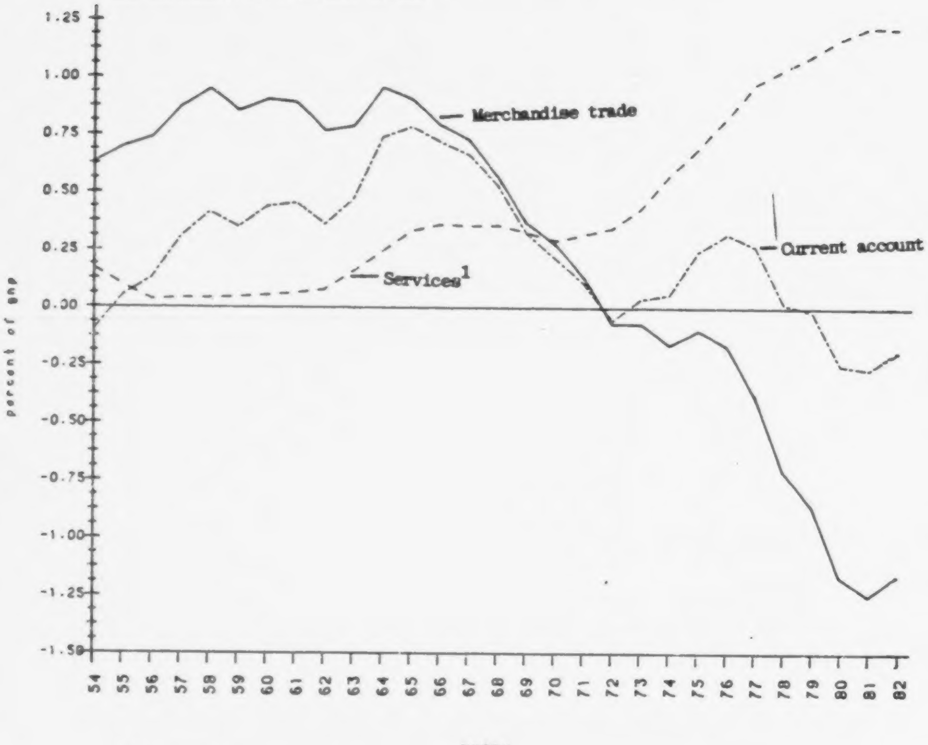
10. A complete program for bringing the federal deficit close to balance by 1989 is outlined in Alice M. Rivlin, ed., Economic Choices 1984 (Brookings, 1984).

But none of these measures will prevent a dramatic increase in protectionism unless U.S. fiscal policies are changed.

U.S. policymakers need to do more than provide a downpayment to reduce the fiscal deficit. They need an installment plan, which will provide clear and credible signals to financial markets that the nation has a strategy for restoring national spending patterns to sustainable levels.

Figure 1. U.S. Balances on Current Account, Merchandise Trade, and Services, as a Percent of GNP[a]

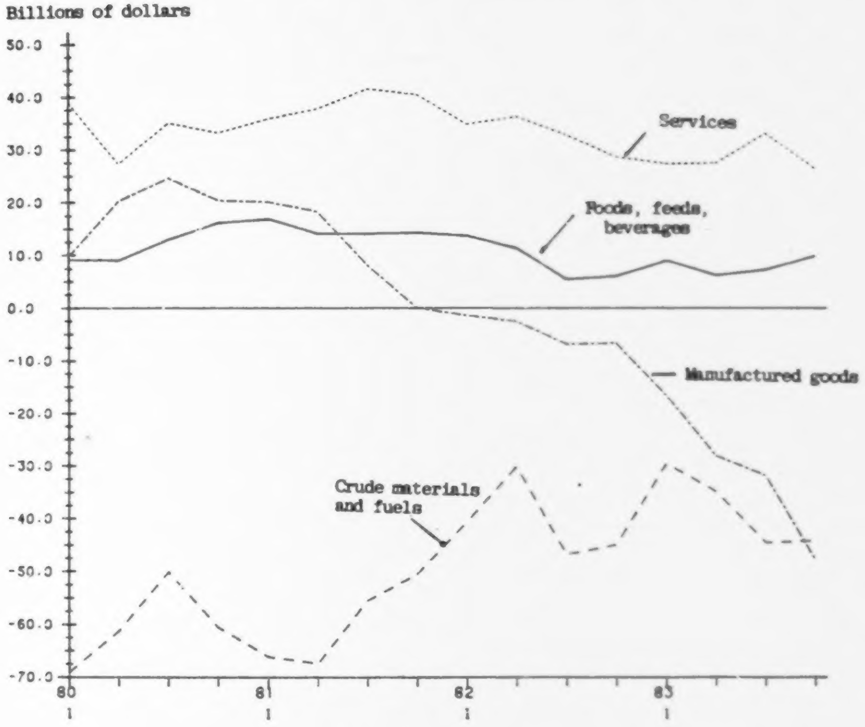


[1] Includes investment income, military transactions, travel, transportation, fees and royalties, and other services.

Source: Economic Report of the President, February 1984.

a. Five-year moving averages.

Figure 2. Major Components of U.S. Merchandise Trade Balance, 1980-83[a]



Source: Economic Report of the President, February 1984.

a. Quarterly values as annual rates.

STATEMENT OF DR. GARY C. HUFBAUER, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Senator DANFORTH. Dr. Hufbauer.

Dr. HUFBAUER. Mr. Chairman, the first issue is whether there is an issue. The lead editorial in today's Wall Street Journal tells us that the monster deficit will soon be decapitated by rampant U.S. growth with no need to call on new tax increases or big spending cuts. The front page of the Wall Street Journal cites a number of forecasters who say that the U.S. trade deficit will decline in 1985 and beyond, thanks to growth abroad and natural forces in the foreign exchange markets.

I hesitate to disagree with the Wall Street Journal, but I don't subscribe to this optimistic scenario. This brings me to the question of alternative solutions. I certainly have no quarrel with those who want to make more progress on the Federal deficit. God speed. But even with the best efforts, it will be, as you said, a long, long time before we turn the Federal budget around.

So that brings me to the question of more immediate solutions. In my written testimony, I have outlined three unorthodox solutions. The world of unorthodox solutions is large. I am sure there are many other solutions in that world.

Let me briefly list my own solutions and then leave time for questions.

First unorthodox solution: A new approach to exchange rates. I suggest a new emphasis by the Fed on real exchange rates, an emphasis that I think can be effective in bringing the dollar down gradually over time, without stoking up inflationary fires through excessively rapid monetary growth.

Second unorthodox solution: I advocate a change in GATT rules so that all direct taxes can be rebated on exports and imposed on imports. I would, however, add the important following qualification: This new system should be phased in so that a country must first experience, as the United States is now experiencing, a large and persistent current account deficit before it can implement the new system of border tax rules.

Third unorthodox solution: A new commitment by countries in persistent current account surplus to unilaterally and automatically liberalize their trading practices. As an interim measure, I would allow the persistent surplus countries to impose taxes on their exports and grant bounties on their imports. As an ultimate prod, I would permit deficit countries to impose directional tariffs on their imports from surplus countries. But the tax bounty system that I just mentioned and the ultimate prod of directional tariffs are just aids to the larger goal. My solution calls on surplus countries to liberalize their protective practices sector by sector in an aggressive fashion so as to bring down their current account surpluses.

A solution along this line, rather than along the trade restrictive lines that we normally see, would help restore a dynamic quality to the world trading system. And when you look at the trade statistics of the last 5 years, I think it's evident that we need to recapture the dynamism of the 1960's.

Thank you.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Dr. Hufbauer follows:]

THE U.S. TRADE DEFICIT:
THREE UNORTHODOX SOLUTIONS

Statement by
Gary Clyde Hufbauer
Senior Fellow
Institute for International Economics

Before the
Subcommittee on Trade
Senate Finance Committee
of the
United States Congress

June 28, 1984

The Background: A Familiar Story

There is broad agreement on how we arrived at a merchandise trade deficit of $120 billion and rising.[1] Loose fiscal policy has depleted the pool of American savings, creating ample room for an inward flood of foreign savings. Tight monetary policy has raised the yields on U.S. financial assets and made them highly attractive to foreigners. Concurrently, the substantial appreciation of the U.S. dollar against foreign currencies has made American goods hugely overpriced on world markets and foreign goods exceptionally cheap to American buyers.[2] Additional ingredients are lower imports by the debt-burdened countries of Latin America, and a lagging business cycle in Europe and Japan. The result: a $120 billion merchandise trade deficit.

One camp says that we should watch the deterioration carefully, pray for smaller budget deficits and faster foreign growth, but otherwise do nothing.[3] Enthusiastic supply-siders believe that Federal budget deficits will soon be curbed by spending restraint and fast U.S. growth, with no need for painful tax increases.[4] Others in the do-nothing camp say that large budget deficits are likely to persist, that their reduction requires work as well as prayer, but that, in the meantime, inflows of foreign capital and a corresponding trade deficit help finance our fiscal excesses and hold down inflation.[5] The do-nothing camp believes that, so long as foreigners are willing to buy U.S. financial assets, all is well. And, when foreigners no longer want to acquire U.S. assets, the dollar will decline. Again all will be well.

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[1] A merchandise trade deficit of $120 billion implies a current account deficit of $90-$100 billion.

[2] The international consequences of President Reagan's economic package were predictable and even predicted. See, Gary Clyde Hufbauer, U.S. International Economic Policy 1981: A Draft Report, International Law Institute, Georgetown University, Washington, D.C., April 1982. Also see, C. Fred Bergsten, "The International Implications of Reaganomics," Kieler Vortrage 96, February 1982.

A second camp of thought sees three dangers with the watch and do-nothing approach.[6]

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3. See, for example, Economic Report of the President, February 1984, chapter 2.

4. Paul Craig Roberts, "The Deficit Scare Has All But Faded Away, Business Week, June 25, 1984, p. 16.

5. Martin Feldstein, "Improving the Trade Balance: Deficit Reduction, Not Tariff Surcharge," Statement before the Subcommittee on Trade of the House Ways and Means Committee, March 29, 1984.

6. See, for example, Stephen Marris, "Crisis Ahead for the Dollar", Fortune, December 26, 1983, p. 25, and C. Fred Bergsten, "The United States Trade Deficit and the Dollar," Statement before the Subcommittee on International Finance and Monetary Policy of the Senate Committee on Banking, Housing and Urban Affairs, June 6, 1984.

First, the U.S. dollar could abruptly collapse, with adverse consequences for world financial stability. A 20 percent decline in the exchange value of the dollar over two years is one thing; a 20 percent decline over two months is quite another.[7]

Second, until the great collapse occurs, the sectors of the U.S. economy that produce traded goods will suffer enormously, both from import competition and lost export sales.

Third, foreign competition built on misaligned exchange rates will increase protectionist pressure within the United States. As protectionist pressure is translated into protectionist action, an unfortunate demonstration effect will occur around the world.

I associate myself with this second camp. Like most members of both camps, I would welcome resolute reduction of the Federal budget deficit. Alas, the modest "down payment" bill appears to have exhausted Administration and Congressional enthusiasm for higher taxes and lower spending. Perhaps 1985 will bring a renewed assault. In the meantime, it would seem prudent to explore alternative measures that address the trade deficit directly. Before turning to some of my own unorthodox suggestions, I should say something about the broader savings-investment context of all trade deficit solutions.

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[7] I hasten to add that neither Marris nor Bergsten foresees a decline as drastic as 20 percent in two months.

Any measures designed to decrease the trade deficit that do not simultaneously reduce the budget deficit will necessarily entail either an increase in some other category of savings or a decrease in investment. An increase in some other type of savings is much to be preferred over a decrease in investment.

Table 1 gives the U.S. savings-investment balance for 1983 (preliminary data), and my own estimates (based in part on DRI forecasts) for 1984 and 1986. My projections for 1986 assume a $25 billion inflow of savings from abroad,[8] a modest rise in personal savings, and little reduction of the federal deficit. My projections also assume a continuation of the very desirable rise (though at a slower pace) of gross private domestic investment.

I believe that the great bulk of additional savings needed to finance the rising level of private domestic investment and to replace foreign savings will have to be supplied by business. In other words, policy measures that meaningfully improve the trade account will, at the same time, have to facilitate a rapid increase in business savings. The requisite jump in business savings probably means that prices will have to rise faster than wage costs per unit of output. This in turn means that corporate profits must rise more sharply than GNP. I see nothing wrong

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[8] This corresponds to a merchandise trade deficit of about $40-$50 billion in 1986. In other words, I am assuming that a combination of exchange rate changes, slower growth at home and faster growth abroad, and deliberate policy measures will work to reduce the trade deficit by $70 to $80 billion over the next two years.

Table 1. Estimated Sources of Gross U.S. Savings, $ billions.

	1983	1984 est.	1986 est.
Net savings from abroad	35	95	25
Personal savings	114	130	150
Gross business savings	455	480	645
Federal deficit	-182	-180	-175
State and local surplus	51	65	55
Total savings available for domestic use	472	590	700
Gross private domestic investment	472	590	700
GNP	3311	3650	4260
Total savings as percent of GNP	14.3%	16.2%	16.4%
Gross business savings as percent of GNP	13.7%	13.2%	15.1%

Source: For 1983, Survey of Current Business, April 1984; for 1984 and 1986, author's estimates based in part on Data Resources, Inc. forecasts.

with surging corporate profits. U.S. corporate profits have been too low for too long. But I hasten to add that not everyone would agree with this judgment.

What follows are three unorthodox approaches for dealing directly with the trade deficit. Other solutions are certainly possible. In any event, the trade deficit is now so large that a combination of measures, including a large dose of budget restraint and substantial foreign growth, will be needed to restore order to our internatinal accounts.

First Solution: A New Exchange Rate Policy

When the leading nations, at U.S. urging, adopted a system of floating exchange rates in 1973, it was widely believed that exchange rate fluctuations would ensure that the current account position of each of the major trading nations would stay roughly balanced. Events have not worked out that way. Ever larger capital flows have come to dominate the exchange of goods and services. The question now is whether exchange rates should be managed to achieve their "implied promise". I believe they should.

Three points are relevant to the question of how exchange rates can be managed.

First, the Fed already looks at other variables, in addition to the money supply, when it determines monetary policy. Indeed, the Fed's target cones of monetary growth are wide enough for a supertanker to turn in; and if money growth by one definition or another bumps against its boundary at an inconvenient moment, the lane is simply redrawn.

Second, while the Fed looks at other variables such as interest rates, GNP growth and inflation rates, it pays little or no attention to the real exchange rate between the United States dollar and key foreign currencies. (The real exchange rate is calculated by adjusting the nominal exchange rate for differential inflation between the United States and its trading partners). Changes in the real exchange rate are critically important in determining the U.S. merchandise trade deficit and deserve greater policy attention.[9]

Third, the Fed has enormous "announcement powers." It can influence financial markets by mere whispers. Look what happens to bond markets when Paul Volcker suggests that the economy is overheating or underheating. Small actions by the Fed can move financial mountains.

Bearing these points in mind, I think that the overvalued dollar can be corrected without much change in the present

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9. For more on this subject, see John Williamson, The Exchange Rate System, Institute for International Economics, Washington, D.C., September 1983.

eclectic approach to monetary policy. What is needed is an announced change in emphasis. What the Fed needs to say is that it will pay attention to real exchange rates. Then the Fed needs to back up this statement by actively intervening in the exchange markets on a sufficient scale in a manner carefully timed to catch the speculative winds rather than fight them.[10] A 20 percent decline in the dollar, engineered over a two-year period, would curb the trade deficit and, at the same time, improve the earnings of U.S. firms that compete with imports or sell their goods in export markets.

An important technical question deserves mention: should exchange rate intervention by the Fed be "sterilized" (i.e., offset by equivalent sales of U.S. Treasury bills, leaving no net effect on the U.S. monetary base) or should it be "unsterilized" (i.e., allowed to increase the monetary base)? I believe that sterilized intervention -- if pursued adroitly and resolutely, without the usual nay-saying by senior Treasury and Fed officials -- could dramatically change sentiment in the foreign exchange markets and create the right atmosphere for a very substantial correction in the exchange value of the dollar. Many of my professional colleagues disagree; they think that only unsterilized intervention, with its attendant inflationary risks, would do the trick. Whatever the merits of this academic debate,

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[10] For more, see Ronald I. McKinnon, An International Standard for Monetary Stabilization, Institute for International Economics, Washington, D.C., March 1984.

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the right strategy for the Fed is not to announce a strategy. Monetary policy is best played like a poker game: don't show your cards. If the markets know that the Fed is watching real exchange rates, but do not know whether Fed intervention will be sterilized or unsterilized, then the Fed can play the strongest hand with the least inflationary risk.

Second solution: import tariff and export bounty

A possible answer to the grotesque merchandise trade deficit is to impose a balance-of-payments tariff on all imports at a rate say, of 20%, and to provide an equivalent bounty on all exports. This solution was roundly condemned by Martin Feldstein when he appeared before the House Ways and Means Committee.

One argument against the tariff/bounty approach is that it would move the exchange rate in the wrong direction, thereby offsetting some of the competitive gain. I doubt very much that the induced exchange rate change would completely offset the competitive gain.

Another argument is that a tariff/bounty approach runs against GATT strictures. Balance of payments quotas are, in fact, permitted by GATT Article XII. Balance of payments tariffs and bounties are a superior adjustment tool, less disruptive of market forces than balance of payments quotas. Unfortunately, this superiority is not openly acknowledged in the GATT. It can be argued that balance of payments tariffs are implicitly permitted, both by the wording of Article XII and by evolving pratice, but the same cannot be said of balance of payments bounties.

A third argument against the tariff/bounty approach is that it would poison the well for international negotiations aimed at liberalizing trade and could trigger a harmful round of imitation. I think this is the most forceful argument.

All in all, I prefer to marry the economic logic of a tariff/bounty approach with an old idea that has its own logic: border tax adjustments for direct taxes.

In my view all direct taxes -- corporate and personal income taxes and social security taxes -- should be imposed on imports and rebated on exports.[11] This proposal is spelled out in more detail elsewhere.[12] The basic idea is that all direct taxes paid on export earnings would be rebated and all direct taxes imposed on import competing industries would be collected at the border. The system is approximately revenue neutral; but it would dramatically change the price map facing U.S. producers. On average, according to my estimates, U.S. imports would be about 20 percent more expensive and U.S. exports about 20 percent cheaper following implementation of a border adjustment system for direct taxes. Price changes of this magnitude would clearly add to the profit and output levels of firms making traded goods, especially those in highly-taxed industries.

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[11] See Gary Clyde Hufbauer and Joanna Shelton Erb, Subsidies in International Trade, Institute for International Economics, forthcoming 1984.

[12] Thomas Horst and Gary Hufbauer, "International Tax Issues: Aspects of Basic Income Tax Reform," in Charls E. Walker and Mark A. Bloomfield, editors, New Directions in Federal Tax Policy for the 1980s, Ballinger Publishing Co., Cambridge, Massachusetts, 1983.

Border adjustment for direct taxes is not now permitted by GATT. The GATT Subsidies Code should be modified, on an emergency basis, to deal with an emergency problem -- namely the U.S. trade deficit. I would add one important qualification. Rebates and taxes should be phased in according to "need": a country must first incur large and persistent current account deficits before it can implement the new border tax adjustment system.

With this qualification, the United States could implement border adjustments as soon as its administrative machinery was ready; Japan and most European countries would have to wait until they experienced large current account deficits for some period of time before implementing the same system.

This proposal should not in any way obstruct the growing support for consumption-based taxation. True, under present GATT rules, consumption taxes can be imposed on imports and rebated on exports. But I have never thought that the main reason for adopting consumption-based taxation was to secure the advantage of the present, unduly restrictive, GATT border-adjustment rules. Rather, the rules should be broadened so that direct and indirect taxes are treated in an equivalent manner.

Another approach to the trade deficit would have foreign countries tax their exports of capital to the United States, or would have the United States tax its capital inflows from abroad. The taxation of capital flows would lower the exchange rate, thereby encouraging exports and discouraging imports. In broad terms, the impact of capital taxes on the trade deficit is similar to the solutions already mentioned. But I have two problems with taxing the international flow of capital. First, such taxes are extraordinarily difficult to administer and they invite the creation of loopholes. Second, if effective, they would raise the interest-rate differential between the cost of funds to U.S. firms and the cost of funds to foreign firms. A larger differential would disadvantage firms doing business in the United States.[13]

Third solution: harnessing the wind

While the present U.S. trade deficit finds its origins in a bizarre combination of monetary and fiscal policy, those origins should not prevent us from harnessing the resulting wind to the good ship "trade liberalization".

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[13] In effect, a foreign tax on exported capital would offset the recent decision to repeal the 30 percent U.S. withholding tax on interest paid to foreigners.

In my view, each of the major trading nations -- starting with the seven summit countries -- should accept the obligation to unilaterally and automatically liberalize its trading practices when that country runs a persistent current account surplus. Just such an approach was the de facto policy of the United States during the years of dollar surplus, from the late 1940s to the early 1960s. Concessions given by the United States during the first five rounds of GATT tariff negotiations were much larger than concessions received from Europe or Japan. Similarly, in the 1950s, the European nations fulfilled more of their non-discrimination commitments every time their balance of payments improved. Unfortunately, in recent years, as other major trading countries have become surplus countries, they have not stepped up to assume the same obligations to the international system. Instead, the view has come to be accepted that the deficit country should shoulder the burden of adjustment. And the deficit country often resorts to solutions that restrict trade.

Elsewhere, I have spelled out an approach that would link unilateral and automatic trade liberalization to current account surpluses.[14] I would require concessions to be respond to the request lists of countries with current account deficits. As an interim measure, surplus countries could grant bounties on their imports and impose taxes on their exports, an approach that runs into no GATT difficulties.[15] As an ultimate (and hopefully little used) means of persuasion, I would permit deficit countries to impose low rate directional tariffs on their imports from surplus countries.[16]

But the main point is not the details. Rather, the central idea is acceptance by major trading countries of their duty to liberalize unilaterally and automatically whenever their current accounts are in surplus for an extended period of time. The amount of liberalization should fully correspond to the size of the surplus. Applied today, this principle would require Japan to liberalize on a grand scale -- with no concessions asked. Applied five years from now, this principle could require the United States to liberalize -- again with no concessions asked. These are weighty obligations. But they could help restore the dynamic process of liberalization that so greatly benefited all countries during the 1950s and 1960s.

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[14] Gary Clyde Hufbauer, "The Unconditional Most-Favored-Nation Principle: Should it be Revived, Retired or Recast?" Conference on International Trade Problems and Policies, Monash University, Melbourne, Australia, February 13-14, 1984.

[15] However, the United States (and perhaps some other countries) would encounter domestic constitutional barriers to the imposition of export taxes.

[16] This step would require a waiver of GATT rights by target countries. Such a waiver might prove more acceptable if undertaken jointly and prospectively.

Conclusion

Objections can certainly be raised to these solutions. None is painless or easy. Other solutions may be better. Perhaps the best thing is to work for smaller budget deficits in 1985, wait for Europe and Japan to increase their growth relative to the United States, but otherwise do nothing. But if orthodox remedies could correct the trade deficit, or if easy and painless solutions were at hand, or if everyone agreed that the trade deficit must remain hostage to domestic budget politics and foreign growth, then the subject would scarcely merit Senatorial attention.

Senator DANFORTH. Mr. Lawrence, do you have any suggestions on the best way to reduce the deficit? For example, would you favor a value-added tax as a way of producing revenues?

Mr. LAWRENCE. We are talking about the fiscal deficit?

Senator DANFORTH. That's right. Deficit in the budget.

Mr. LAWRENCE. Well, I think that we do need some tax reform. But I believe that trying to put in place a brand new form of taxation would hinder speedy action on the question of the deficit. And, therefore, I believe that it should come in the form of a surcharge. Let's take care of the deficit problem and then move to deal with the important question of tax reform thereafter.

I know that many people think the opposite. They think it will provide a pretext for raising taxes. If we do it in a new form, it's going to be easier. I'm somewhat more skeptical. In particular, it's really a question of political judgment. Bringing the deficit down is so urgent that I would prefer a simple and direct method to do that.

Senator DANFORTH. What we have been doing so far is just pasting together long lists of specific measures. It's agonizing to do that, and it takes forever.

Mr. LAWRENCE. And you see what I tried to illustrate is that it is not necessary to bring down the deficit, of course, all at once in one go. That would be a disastrous move. But it is necessary to have in place an installment plan: not just a down payment. We have to see clearly where we are heading over time. That, I believe, would have salutary effects on the financial market.

Senator DANFORTH. Dr. Hufbauer, your testimony has been really most interesting. I take it you are not proposing unorthodox measures for the sake of being unorthodox. You are suggesting unorthodox measures because you think that conventional measures aren't adequate any more. Or are you just being thought provoking?

Dr. **Hufbauer**. Well, it's late in the day. You are very patient to stay, and I thought it would make things more interesting if I had something unusual. But in fact, I do believe that it's time to consider new approaches.

Senator **Danforth**. Would it reflect your view to say that our present trading system just doesn't work anymore?

Dr. **Hufbauer**. I think that's too strong. I think the trading system is working, but I think we have unusual monetary and fiscal policies that are exerting earthquake-like shocks on the trading system. We need major remedies to deal with those shocks.

Senator **Danforth**. Your idea of a tax system which taxes imports and rebates at the border, is that identical to a value added tax? Are you talking about a consumption tax specifically that would work that way or something other than a value added tax.

Dr. **Hufbauer**. Very briefly, I think the international effects that can be achieved under the GATT system with the value added tax can be achieved directly by allowing adjustment at the border for the present taxes that we have—that is, our present system of corporate income taxes, personal income taxes, and Social Security taxes. I have gone into this at some length in one of the articles that I cited.

The upshot is that we do not need a value added tax system or a consumption tax system in order to achieve the international economic results that those systems bring about. What we need is a change in the GATT rules. And that's what I'm advocating.

Senator **Danforth**. How do we do that? Do we just announce to the world the time has come to change the GATT rules? Do you think we have that kind of clout to do that?

Dr. **Hufbauer**. Yes, if done resolutely, I think that's possible.

Senator **Danforth**. I'm sorry, I interrupted you.

Dr. **Hufbauer**. The announcement approach that you mentioned is the approach we would probably have to follow. Maybe the trade crisis will have to get worse before we come around to that, but we are headed there, in my judgment.

I am for consumption taxes and the value added tax. I guess I disagree with Robert Lawrence. I think the present tax system is pretty hopeless and will need major reforms to raise the necessary revenue. I would prefer to start over with a value added or consumption tax. But I don't urge that course simply to take advantage of the present GATT rules. I would change the GATT rules and deal with the tax system as a separate question.

Senator **Danforth**. How about the surcharge that was suggested by Mr. Mitchell?

Dr. **Hufbauer**. As I mentioned in my testimony, I think that would trigger a wave of protectionist thinking and response abroad and would pretty well derail our broader liberalization efforts. That's the reason I advocate a change in the GATT rules.

Senator **Danforth**. With respect to your suggestion that countries with trade surpluses impose an export tax and an import bounty of some kind, if we were to go to Japan and say, well, we have decided that we just don't like this trade surplus that you have anymore, and we would like you to tax Toyotas and have some sort of a rebate program on whatever we want to send over there. What do you think their reaction would be? Will they tell us to just go roll our hoop?

Dr. **Hufbauer**. If I could just briefly restate my proposal. I believe that Japan has an obligation, in today's circumstances, to liberalize unilaterally and automatically. And there is plenty of liberalization that Japan could do. NTT could have completely liberalized its procurement by this time, but NTT has just made some small concessions.

Senator **Danforth**. They just had the delegation going around this country.

Dr. **Hufbauer**. It's great for the hotel business in this country, but it has yet to yield many exports. There remains a great deal that Japan can do. Now as an interim measure, I would permit Japan—and the GATT rules do permit Japan—to put a tax on her exports and to put a bounty on her imports.

Senator **Danforth**. Why would they do that though? Wouldn't that cause a furor?

Dr. **Hufbauer**. I think we have to step back and look at what other countries—the United States and Europe—did when they were surplus countries.

Senator **Danforth**. Japan is No. 1, and we think of them as thinking of themselves first.

Dr. **Hufbauer**. I think attitudes change. I think Japan recognizes the value of the world trading system. I think there are forces of liberalization at work in Japan, and I think those forces need to be encouraged. Again, I believe in a resolute "announcement" approach. You can't be timid about these things, and we shouldn't be timid.

Senator **Danforth**. What do you think, Mr. Lawrence? Do you agree with Dr. Hufbauer or are you sticking by your guns?

Mr. **Lawrence**. Well, respectfully, no, I don't think his proposals would actually be effective in dealing with the problem that he is trying to address. I think if we took the proposition that what the Japanese ought to do is to now use border taxes in an effort to change their trade flows. I think it reflects, respectfully again, a fundamental misunderstanding of what a current account deficit is. It's an indication that the Japanese as a nation are saving more than they are investing at home. And, therefore, if you find the Japanese current account a problem—and many do—and if you find our current account a problem—and many do—we have to direct our attention to the macroeconomic policies of the two countries.

If we want to reduce the current account of the Japanese, the surplus, we have to persuade them to reduce their savings. We can do that either by trying to get their government to expand its spending or to cut taxes to follow the fiscal policy that our country has followed. That's what we should be advising them to do.

We could look in the defense area. That's one area in which we may suggest that they increase their spending. But it's focusing on the spending patterns of the two countries, it seems to me, that you have to direct your attention to if you want to——

Senator **Danforth**. Dr. Hufbauer wouldn't disagree with that. He would just say that that is not going to do it.

Dr. **Hufbauer**. Well, it's hard to change our own fiscal policies and monetary policies. I think it's just one degree harder to get the Japanese to change theirs.

Mr. **Lawrence**. But let me just point out that if Mr. Hufbauer's policies are successful, we will have a smaller trade deficit. We will be borrowing less from the rest of the world. We will have higher interest rates and less investment in this country. So it's choosing between two bads, if you will.

The only solution in my judgment is to change the fiscal deficit because then we don't lose out on investment.

Senator **Danforth**. Gentlemen, I really appreciate your joint participation. I think that this has been an excellent forum for both of you and I think you both have done a very good job. I agree with everybody. I mean I agree with you on the deficit, Mr. Lawrence. [Laughter.]

But I also agree that we have to do more than just deal with the deficit problem. I am increasingly of the view myself that the time has come for unorthodox solutions to a major problem. I think you have really furthered our thinking today. Thank you both.

This concludes the hearing.

[Whereupon, at 12:07 p.m., the hearing was concluded.]

84-49

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE, ON THE U.S. TRADE DEFICIT

June 28, 1984

The AFL-CIO appreciates this opportunity to comment on the serious problem of the large and rapidly growing U.S. trade deficit. The sharp deterioration of the international economic position of the U.S. in recent years has had a profound and negative impact on scores of domestic industries and millions of American workers. Recognition of the seriousness of this problem, as evidenced by these hearings, is particularly welcome and stands in sharp contrast to what can only be viewed as studied indifference on the part of the Administration.

The unwillingness of the Administration to take steps to arrest the decline of the U.S. position was outlined in the most recent Economic Report of the President. While noting the record U.S. trade deficits, President Reagan merely reiterates his belief in free trade, and rejects governmental action, in the apparent hope that through reliance on market forces, the problem will correct itself at some point in the future. He states in part:

"Despite these problems, I remain committed to the principle of free trade as the best way to bring the benefits of competition to American consumers and businesses. It would be totally inappropriate to respond by erecting trade barriers or by using taxpayers' dollars to subsidize exports. Instead, we must work with the other nations of the world to reduce the export subsidies and import barriers that currently hurt U.S. farmers, businesses, and workers.

"I am also firmly opposed to any attempt to depress the dollar's exchange value by intervention in international currency markets. Pure exchange market intervention cannot offset the fundamental factors that determine the dollar's value . . . The dollar must therefore be allowed to seek its natural value without exchange market intervention."

The tragedy of this approach is that the U.S. is frequently left defenseless in the international arena. By emphasizing, even rhetorically, the "value" of free trade, questions of national interest tend to be dismissed, or at least relegated to a lower status, and success is measured not by the health of the domestic economy, but by one's adherence to a theoretical construct. That the "free market" really doesn't exist is somehow forgotten.

It should be clear by now that our trading partners have a different conception of what "free trade" is all about. Other countries see trade as a means to the larger goal of balanced economic development and employment. While it is true that tariffs have been lowered through successive rounds of multilateral trade negotiations, a new array of non-tariff barriers such as quotas, stringent inspection requirements, exchange rate manipulation, discriminatory standards, buy national policies, export subsidies, industrial targeting programs, and trade arrangements such as performance requirements, co-production, offset and barter agreements have developed.

Continued attempts by the U.S. to reduce the use of these measures have just not been successful, and our own market remains wide open to an ever increasing volume of imports.

This trade policy framework, together with the ill-conceived monetary and fiscal policies of the Administration, has contributed significantly to the massive trade deficits the U.S. faces today.

The dimensions of this problem are startling. The U.S. merchandise trade deficit for 1983 reached a record $69.4 billion, 63 percent greater than the previous record of $42.7 billion set the year before. The current Administration predicts this economic decline will continue in 1984 with the deficit reaching $120 billion. This deterioration in the trade position of the U.S. is estimated by Data Resources, Inc. to be responsible for the loss of more than two and one-half million jobs, three-quarters of which are in the manufacturing sector.

While these figures are chilling in and of themselves, a look at the composition of the trade deficit paints an even darker picture. In 1983, the United States recorded surpluses in only two merchandise trade sectors — agriculture products and chemicals. America's trade position in manufactured products collapsed. The U.S. has basically become an exporter of raw materials and commodities, and an importer of finished goods. In fuel trade, a sector which has traditionally contributed a large part of our merchandise trade deficit, the U.S. position has been improving over the last 3 years. In 1980, the United States registered a deficit of $78 billion for this sector. In 1983, this deficit had been reduced to $51 billion, a drop of 35 percent. While exports rose moderately, imports were significantly reduced.

Between 1980 and 1983, U.S. manufacturing exports had fallen 8 percent, while manufactured imports had increased 30 percent. In 1980, the U.S. enjoyed a surplus of $12.5 billion in this sector. By 1983, this surplus had vanished and the U.S. recorded a deficit in manufacturing trade in excess of $38 billion. So far in 1984, the U.S.

has been running a manufacturing trade deficit of more than $7 billion per month.

Should this pattern continue as expected, the manufacturing deficit will reach $87 billion in 1984. This represents a decline of almost $100 billion in manufactured trade balance since 1980.

All manufacturing sectors have contributed to this dramatic turnaround in the U.S. position. From 1980 to 1983, the U.S. surplus in the chemical sector fell 28 percent. Exports dropped 5 percent and imports rose 25 percent. For manufactured goods classified chiefly by material (tires, paper, textile fabric, iron and steel, non-ferrous metal), the U.S. deficit increased by 85 percent to $21.9 billion. In the machinery and transport equipment sector, the U.S. position totally reversed itself going from a $21.2 billion surplus in 1980 to a deficit of $6.4 billion in 1983. Exports fell by 2.4 percent, while imports increased by 40 percent. For miscellaneous manufactured articles, the U.S. deficit more than doubled from $8.7 billion in 1980 to $18.4 billion in 1983. Exports dropped 6.7 percent and imports rose 34.3 percent. While it is clear that U.S. exports have declined across the board, the tremendous increases in imports bear primary responsiblity for the huge and growing deficits.

Examination of U.S. trade on a bilateral basis paints an equally dismal picture. In 1983, the United States experienced a $14.3 billion deficit with Canada; a $1.5 billion deficit with the European Economic Community; a $1.7 billion deficit with South Korea; a $7.4 billion deficit with Taiwan; an $8 billion deficit with Mexico, and a record $21.9 billion deficit with Japan.

As dramatic as these numbers are, they may very well understate the impact on U.S. employment.

The most fundamental problem is that published data measures trade flows in dollars, rather than physical quantities. This invariably understates the job losses caused by imports. Because of low labor costs in many of the countries where U.S. imports originate, a dollar of imports displaces more than one dollar of U.S. production of the same item. Accordingly, the use of unadjusted dollar values to measure the employment effects of imports significantly understates the job losses in the U.S.

A factor which has made dollar-denominated measures of trade flows even less reliable is the sharp rise in the foreign exchange value of the dollar. The appreciation of the U.S. dollar raises the foreign price of U.S. exports and cheapens the U.S. price of import goods. An appreciating dollar increases the employment impact per billion dollars of U.S. imports. From July 1980 to April 1984, the exchange value of the U.S. dollar increased by 53 percent relative to the currencies of other major developed countries. Moreover, sizable devaluations in many developing countries further increased the value of the dollar on foreign exchange markets, causing even greater employment effects per billion dollars of imports.

This massive increase in the dollars' exchange value has been a significant contributor to the collapse of the trade position of the United States. The appreciation is no different than a 53 percent tax on exports, and a 53 percent advantage for importers. That the dollar is overvalued is now almost universally acknowledged, even by some within the Administration. It is clear that this currency misalignment is placing severe costs on American industry and workers, and makes discussions on the need to increase competitiveness almost irrelevant. Should workers in export industries be forced to take a 53 percent paycut in order to restore their products' international competitiveness? I think not. The problem is not with American workers or U.S. industry, but with the policies of their government.

A major, if not principle, cause of the overvaluation of the dollar is the irresponsible fiscal and monetary policies of the Reagan Administration. Huge tax giveaways and unfinanced increases in defense spending has led to the huge budget deficits facing America today. These budget deficits, together with the tight money, high interest rate policies of the Federal Reserve Board, have kept U.S. interest rates high, encouraging massive capital inflows to the U.S. and, therefore, keeping the dollar artifically strong. These same capital inflows have to some degree slowed the capital exporting countries' economic growth by reducing their own pool of investment funds. Their slower growth rates have reduced their ability to purchase U.S. goods.

Similarly, high interest rates in the U.S. have significantly increased the magnitude of the debt crisis facing many developing countries. The higher debt service costs reduce their ability to buy U.S. goods and increases their need to acquire dollars through exports to the U.S.

Another aspect of this fiscal and monetary tragedy is that as U.S. firms find themselves being priced out of the international market due to the overvalued dollar, they may view relocation overseas as a viable alternative. Given the relative openness of the American market to foreign goods, further U.S. employment losses could occur.

Given these trade and economic policies, it is little wonder that the U.S. is facing a trade crisis.

The AFL-CIO believes that the goal of U.S. trade policy must be the attainment of a fair trading environment that allows this nation to remain an advanced and diversified economy, while promoting full employment and rising living standards in the United States and other countries of the world.

"Fair trade" means that the interests of the U.S. must receive greater emphasis in both the domestic and international initiatives of U.S. international trade and investment policy.

The United States must retain its manufacturing, agricultural, and maritime industries. The nation's foreign trade policy and its domestic economic policies must promote — not undermine — this goal. The trade problems facing the country are immense, and there is no one single action that will alleviate that problem. Rather the government must undertake a variety of specific actions to deal with the trade crisis.

First and foremost, U.S. trade law must be strengthened to reflect international trading realities. It is time to recognize that the principle approach to trade problems taken by the U.S. government — encouraging other countries to stop what are considered to be objectional practices — has failed. While negotiations take place, injury to the U.S. economy continues. The U.S. government must also develop a clearer idea of what interests it serves in implementing trade policy. Earlier this year, Ambassador Brock, in a speech before the National Press Club, said that Japan was risking its entire trading relationship with the U.S. by refusing to adequately relax its quota on U.S. beef exports. He stated the issue "has taken on a symbolic quality way beyond its substance." This is exactly what is wrong with the U.S. approach. In 1983, the U.S. had a large surplus in agricultural trade with Japan, quotas or not. The overall trade balance with Japan however was in deficit by almost $22 billion due to the tremendous imbalance in manufactured goods. That is the trade problem with Japan, not beef.

Attention should be directed at substantive problems, not symbolic issues.

To help accomplish this policy reorientation, legislation is urgently needed to tighten and streamline the laws designed to relieve industries and workers injured by imports.

It is clear that the so-called "fair" and "unfair" trade remedy statutes need improvements. Both "fair" trade laws designed to alleviate trade-induced injury and "unfair" trade laws designed to counteract dumping and subsidies should have better procedures and more effective remedies.

The AFL-CIO believes that the help promised to injured industries for 20 years has not become a reality. The safety valve promised to those who are affected by tariff-cutting and import surges, the so-called "escape clause," now Section 201 of the Trade Act of 1974, has never been effective. Petitions under Section 201 require expensive and extensive documentation. The criteria used by the International Trade Commission (ITC) in making determinations are so vague that findings of injury seldom result. In addition, even if the ITC finds injury on the facts and recommends that Section 201 be invoked as intended by law, the President frequently decides not to implement the action.

The escape clause provisions of the Trade Act should be revised to allow quick relief from trade injury. When a U.S. producer loses sales to foreign producers and reduces his production and workforce accordingly, he knows only that trade has injured his business operation. His workers feel the injury in the resulting layoffs. At this point, the injured parties don't know if the injury was caused by so-called "unfair" trade practices, by "fair" trade practices, by the rising value of the dollar, by foreign currency devaluation, or a combination of these causes. All they know is that the injury is trade related. Such injured parties should be able to receive temporary relief from the injury, and should receive help from the U.S. government to make the appropriate case under the various provisions of the Trade Act that deal with specific relief measures for certain "unfair" and "injurous" trade practices. Many aspects of foreign government subsidy programs and dumping activities are more readily ascertainable by U.S. governmental agencies than by private U.S. parties injured by trade.

For this purpose, the statutory improvements should accomplish three major objectives: (1) To assure that the ITC evaluates more quickly and accurately the impact of imports on an industry and its workers through more specific criteria; (2) To fashion a specific remedy to alleviate temporarily the adverse effect of such imports; and (3) To assure that the President not overturn the determinations of the International Trade Commission except with the explicit agreement of Congress.

For "unfair trade practices," many of the same problems exist: Relief is too little, too late, or not at all. Even for those with access to the financial resources and expertise to seek relief, the time-consuming procedures do not accomplish the intended result. These unfair trade practices procedures also need an overhaul.

Another important need is clarifying and strengthening the authority and procedures designed to identify and eliminate foreign unjustifiable or unreasonable trade policies or acts.

The response to foreign unfair trade practices under Section 301 has proven futile in most cases. The Trade Act of 1979 supposedly authorizes the President to act when another nation's "act, policy or practice . . . is inconsistent with trade agreements" or unjustifiably "burdens or restricts U.S. commerce." In short, when the other nations have unfair practices that affect U.S. exports, this statute is supposed to be a meaningful remedy.

But the detailed, lengthy procedural requirements, the refusal of the U.S. government to act even when the requirements are met, and the failure of the General Agreement on Tariffs and Trade (GATT) process to recognize U.S. rights generally makes Section 301 as presently structured, ineffective to defend U.S. rights.

In addition to these proposals to help all industries hard hit by imports, the AFL-CIO believes that legislation should be enacted to deal with the problems of specific industries:

* Domestic content laws to help assure that the United States remains a producer of automobiles.

* Steel import quotas provided that the steel industry undertakes modernization actions.

* Action to reduce the job-destroying influx of garments, textiles, and footwear now inundating U.S. industry.

* Legislation to revive the U.S. maritime industry to substantially increase the portion of cargo carried in U.S. flagships, and to assure a strong U.S. shipbuilding base, thereby enhancing the national security.

* Policies to maintain and re-establish domestic electronic and television industries.

To address the problem of the overvalued dollar, and indeed the future health of the American economy as a whole, a fundamental restructuring of monetary and fiscal policy is essential. The AFL-CIO has appeared before Congress many times to recommend policies that would help restore fairness and growth to the U.S. economy.

It is clear that President Reagan's supply-side, trickle-down experiment has failed. The huge budget deficits, $195 billion in 1983 alone, created by these misguided policies have helped raise interest rates thereby contributing to the overvalued dollar. Policies should be enacted to restore adequate tax revenues by returning the corporate income tax as a major contributor of these revenues and closing loopholes that allow the wealthy to escape their fair share of taxes. The rapid build-up in military expenditures must also be curbed.

At the same time the tight money policies of the Federal Reserve Board must be redirected and standby credit control authority enacted. Attached to this statement for inclusion in the record are the February 1984 AFL-CIO Executive Council statements detailing our proposals in these areas.

While overall these policy changes are needed to correct the fundamental conditions that have lead to the current exchange rate imbalance, there are specific actions that can be taken now to lessen the damage.

- First, the United States should pursue a policy of currency market intervention, both unilaterally and in conjunction with other countries. The Reagan Administration's inaction in this area is simply an abdication of responsibility.

- Second, attention should be focused on the Administration's refusal to invoke Section 122 of the Trade Act of 1974 which requires the President to impose a surcharge, quotas, or combination of both "whenever" fundamental international exchange rate problems or balance of payments problems dictate. Given the volatility of currency markets, the imposition of quotas would probably be the preferred course of action. While action need not be taken if the President determines that it would be contrary to the national interest, he is required to consult with Congress on that determination. The failure to do even that is but another example of the "do nothing" attitude that prevails in the U.S. government.

It should be emphasized, however, that even if the problem of an overvalued dollar is solved, the U.S., will continue to experience difficulties in trade unless appropriate reforms are made in the areas of trade and industrial policy.

The adoption of a rational and coherent industrial policy is of major importance to the future health of the U.S. economy.

An effective industrial policy to rebuild American industry and achieve sustained, balanced economic growth requires a supportive environment of general economic policies for rapid sustained growth and job creation, including an adequate, equitable revenue base and low interest rates.

The U.S. government has maintained a basically "hands-off" or "laissez-faire" policy toward domestic industrial development and international trade. Other countries have implemented aggressive industrial and trade policies, with substantial success. In steel, auto, electronics, railcars, aircraft, and a host of emerging industries, Japan, the advanced industrial countries of Europe, and the new industrial countries have applied a wide spectrum of strategic government support — from low-cost credit to protection from import competition, and government assistance in technology development. Manufacturing is most important for the health and balance of the U.S. economy, particularly the production of basic commodities which are essential for other production and have national defense implications. Area and regional difference in needs, wealth, and resources also must be taken into consideration in economic policy matters.

The nation must assign top priority to the channeling of resources to modernize private and public facilities and restore the national economy to a condition of balanced growth and full employment. Otherwise, the country will continue to lag in productivity growth and international trade; it will continue to leave significant portions of its human and machine resources idle for extended periods of time; it will continue to suffer a reduction in the standard of living of its people.

A successful industrial policy to rebuild American industry will require the active participation and support of all segments of the American economy, including business, labor and government.

The AFL-CIO proposes the creation of a tripartite National Industrial Policy Board — including representatives of labor, business, and government — which would identify and promote assistance to industries and areas that are vital to national economic growth and employment. Such assistance could include loans and loan guarantees, equity participation, direct subsidies, targeted tax measures in place of across-the-board devices, trade relief, training, research and development, and so forth.

The AFL-CIO believes that the adoption of these measures — trade law reform; a restructuring of monetary and fiscal policy; active intervention in international financial markets; and the inactment of industrial policy will result in achieving the basic goals of our economy — full employment and balanced economic growth.

Enclosures:
AFL-CIO Executive Council Statements on:
(1) High Interest Rates
(2) International Trade and Investment
(3) The National Economy

Statement by the AFL-CIO Executive Council

on

High Interest Rates

February 20, 1984
Bal Harbour, FL

Real interest rates, now at the highest levels since World War II, are distorting the economy by contributing to the overvaluation of the dollar, curtailing public and private investment and pricing homes out of the reach of most workers.

The result is the loss of existing jobs and persistent high levels of unemployment.

High interest rates result from the tight-money policies of the Federal Reserve Board and the Reagan Administration's continued giant budget deficits. Excessive interest rates are a tax that Americans pay to bankers instead of to their government.

High interest rates have been a major contributing factor to the 57 percent increase since July 1980 in the value of the dollar against other major currencies. The higher dollar value raises the price of exports to foreign buyers and lowers the price of imports to U.S. buyers.

High interest rates are crowding out productive investments in the private sector and in state and local government infrastructure.

Mortgage interest rates now in a range of 11½ to 13½ percent compare to rates of 9½ percent in 1978 -- an increase of nearly one-third. Variable rate mortgages threaten to rise even higher in the future. Those new high mortgage rates price many workers out of the housing market.

The continuation of high real interest rates is sowing the seeds of the next recession.

The high interest rates caused by the policies of the Reagan Administration and the Federal Reserve Board must be reversed. The continued high budget deficits must be reduced by raising revenues and curbing the build-up in military expenditures. The

High Interest Rates

Federal Reserve Board must relax its tight monetary policy and refocus on interest rate levels. We urge the Congress to enact H.R. 1742 to re-establish the standby credit control authority that expired in June 1982 and to include on the Federal Reserve Board members from organized labor, small business, agriculture and consumer organizations.

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Statement by the AFL-CIO Executive Council

on

International Trade and Investment

February 20, 1984
Bal Harbour, FL

America's continuing crisis in international trade intensified in 1983 with a record trade deficit of $69 billion. Exports fell by more than $11 billion and imports increased by $15 billion.

The dramatic reversal in America's trading fortunes is demonstrated by the $38 billion deficit in manufactured goods, which was 2½ times greater than the deficit of 1982. Until recent years, manufacturing trade was in surplus.

Despite the resulting loss of jobs and income, the Administration continues to oppose positive action to defend U.S. economic interests. Its "free market" rhetoric does not reflect the trading practices of other countries and does nothing to solve America's trade problems.

The overvaluation of the dollar has greatly contributed to this deficit. Since July 1980, the value of the dollar has risen almost 57 percent against the currencies of our major trading partners, raising the price of exports and lowering the cost of imports. While these distorted exchange rates have had a devastating impact on the domestic economy, the Reagan Administration nevertheless continues the same monetary and fiscal policies that caused this situation. The absence of effective remedies to address domestic injury caused by the growing volume of imports further worsens the impact of these policies.

Although tariff and non-tariff barriers are all but universal among America's trading partners, the U.S. economy remains virtually defenseless, and the Reagan Administration's fixation with "free trade" hinders the adoption of realistic policies.

The AFL-CIO has consistently called for policies that reflect international trading realities and for the abandonment of outdated economic theories. These issues

ENCLOSURE (2)

must be addressed immediately before the industrial base of our country is totally undermined.

- Legislation is urgently needed to tighten and streamline laws to relieve industries and workers injured by imports. Laws dealing with unfair trade practices must be expanded and effectively enforced.
- Domestic content laws are necessary to help assure that the United States remains a producer of automobiles.
- Steel import quotas need to be adopted, provided that the steel industry undertakes modernization actions.
- Congressional action is needed to reduce the job-destroying influx of garments, textiles, and footwear now inundating U.S. industry.
- To revive the U.S. maritime industry, legislation is needed to substantially increase the portion of cargo carried in U.S. flagships and to assure a strong U.S. shipbuilding base, thereby enhancing the national security.
- Export promotion should continue as an important function of trade policy. Export-Import Bank funding should reflect the needs of domestic industry in the export arena but should also be made available for the domestic purchase of U.S. products to offset foreign subsidies.
- Policies should be enacted that assure a significant portion of U.S. raw materials destined for export, such as grains and logs, are processed in this country.
- Policies should be pursued to maintain and reestablish domestic electronic and television industries.
- The prohibition of Alaskan oil exports should be maintained, and U.S.-flag vessels should retain the essential role of distributing the oil to all regions of the country.
- The AFL-CIO reiterates its opposition to Administration requests for tariff-cutting authority. Proposals to eliminate duties on semi-conductors or establish a free trade area with other nations will only serve to increase imports and further damage U.S. industry.

International Trade and Investment

- The AFL-CIO continues to oppose legislation that purports to promote trade reciprocity but merely gives additional authority to the Executive Branch to encourage greater outflows of capital and jobs from the U.S. Realistic reciprocity with other nations is long overdue and should be actively pursued, starting with the enforcement of existing trade law.
- The Administration's proposal for the renewal of the Generalized System of Preferences (GSP), which permits duty-free imports, should be defeated. The AFL-CIO reiterates its opposition to this program, which expires at the end of 1984. At a minimum, Congress must make import-sensitive products ineligible for GSP and limit its application to needy countries.

The AFL-CIO continues to advocate a system of fair trade among nations. Those who denounce our fair-trade proposals as "protectionism" contribute nothing to the solution of the international trade crisis. We insist that all nations play by the same rules.

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Statement by the AFL-CIO Executive Council

on

The National Economy

February 20, 1984
Bal Harbour, FL

The unrealistic budget and economic policies of the Reagan Administration threaten the soundness of our economy for years to come. Continuing high federal deficits are pushing up already high real interest rates and may soon tip the economy into yet another Reagan recession.

The deficit must be reduced by stronger economic growth, increased federal revenues and lower military expenditures.

Fundamental issues for working men and women -- jobs, fairness, and a future with opportunities for all -- are pushed aside by a President who places re-election above the urgent need to take action on these issues.

President Reagan's supply-side trickle-down experiment has failed. It is time to face reality by restoring adequate tax revenues, returning the corporate income tax as a major contributor of these revenues and closing loopholes that allow the wealthy to escape their fair share of taxes. The rapid build-up in military expenditures must be curbed and the destruction of domestic programs must be stopped.

Giant budget deficits raise interest rates, which in turn curtail public and private job creating investments and price homes out of the reach of most workers. High interest rates contribute to the overvaluation of the dollar, which prices U.S. goods out of foreign markets and encourages a flood of imports that undermines domestic employment and production.

A year after the bottom of the Reagan recession, 9 million Americans are still officially unemployed, 1.5 million "discouraged" workers are no longer even counted among the jobless, and almost 6 million workers who want full-time jobs are working only part-time. In January, there were one million more unemployed than when Reagan took office, and two million more than four years ago. The buying power of the average worker's paycheck is lower than in 1979. More Americans are living in poverty today than at any time since poverty statistics were first compiled in the mid-1960s.

Jobs, fairness, and opportunities for the future remain key issues for America's workers and for the nation in 1984.

Jobs

Healthy economic growth based on sound monetary, fiscal and industrial revitalization policies are necessary elements of full employment policies. To achieve progress toward full employment, rebuild the economy and help workers and their communities, we support the following measures now pending before Congress:

1. The industrial policy bill (H.R. 4360), which would set up a high-level Council on Industrial Competitiveness and a Bank for Industrial Competitiveness to make loans and loan guarantees for modernizing and revitalizing American industry.

2. The House-passed community service jobs bill (H.R. 1036 & S. 1812), which would provide public service jobs for workers who cannot find work in the private sector.

3. The public works bill (H.R. 2544), that would help reconstruct the nation's basic infrastructure, including water and sewer facilities, highways and port facilities, and other public works which stimulate private, job-creating investment and economic activity.

4. The plant closing bill (H.R. 2847), which would provide some protection for workers and local communities when industries shut down or move.

5. The House-passed domestic auto content bill (H.R. 1234 & S. 707), to assure a strong U.S. auto industry and additional trade legislation to provide relief for other impacted industries.

Fairness

The Reagan Administration has undermined many statutory protections through Administrative actions and has crippled enforcement of labor standards, civil rights, women's rights, occupational safety and health, environmental safeguards, consumer protections and long-standing anti-trust restraints on corporate power. To restore some element of fairness, major changes must be made. Only the election of a new President will restore proper administration of these basic statutory rights and safeguards. But Congress also has a responsibility for oversight of Administration actions and for enacting additional worker and consumer protections.

The tax giveaways to the wealthy and corporations enacted in 1981 must be reversed. A progressive income tax based on ability to pay must remain a fundamental principle of the tax system. New proposals to heap more of the burden on workers through such regressive devices as value-added taxes, consumption taxes, and flat-rate income taxes must be rejected. Congress should adjust the tax schedule to cap the last installment of the Reagan tax cut at $700, which would recapture $6.9 billion in 1985 revenues, and repeal the costly indexation provisions of the 1981 Act, which would recover another $6.3 billion. Corporations, whose share of the tax burden dropped from 20 percent in 1960 to 10 percent in 1983, must bear their fair share. Tax subsidies for the overseas operation of U.S. multinational corporations must be curbed through elimination of foreign tax credits and deferrals.

The only major revenue proposal of the Reagan Administration is to tax the health insurance of workers and their families. The AFL-CIO will strongly oppose this proposal.

Congress has before it a number of bills that we believe would enhance the fair treatment of the nation's citizens. Therefore we support:

1. The House-passed health care protection for the unemployed (H.R. 3521). This bill would create a modest program of health care for the unemployed and their families.
2. Cost-containment legislation to fight inflation in the health care industry while protecting wages, benefits, and other contractual rights of health care workers and including special protections for public hospitals. However, we will oppose further cutbacks in essential Medicare and Medicaid health care services.

3. Energy price regulation (H.R. 2154 and S. 996), the "Natural Gas Consumer Relief Act" to protect consumers from the monopoly power of natural gas producers, as well as the House-passed restrictions on the export of Alaska Oil (H.R. 3231) to assure that Alaskan oil is used for American consumers.

4. Legislation along the lines of H.R. 100, to end discrimination in pensions and insurance. While that discrimination rests first and foremost on women workers, it affects the entire family through diminished benefits or increased premiums.

5. Consumer protections on telephone rates and service with adequate protection for telephone workers and their pension rights.

6. Worker and union protections in bankruptcy cases to prevent corporations from trying to escape their obligations through phony bankruptcy proceedings. Consumer and worker protections must be provided in any bankruptcy reform legislation, such as H.R. 1147 and S. 333.

7. Legislation (H.R. 1743 and S. 1079) that would prohibit companies which violate the National Labor Relations Act from receiving federal contracts for up to three years.

The Future

In addition to jobs and fairness, America's working people want a secure future, a decent retirement, hope for education and opportunity for their children. To enhance the future of the nation's citizens, new, strong national leadership is required.

Congress now has before it legislation which would make a start toward these goals. We support:

1. Adequate funding for the Elementary and Secondary Education Act, for vocational education, for Adult Basic Education, for student loans and grants, and for other post-secondary and higher-education programs. We oppose President Reagan's schemes for educational vouchers and tuition tax credits as destructive of public education and oppose block grants as inefficient and ineffective methods of funding proven programs.

2. More funds for training and retraining of adult workers, particularly those affected by industrial dislocation.

3. Adequate protections for pension rights. The single-employer pension plan termination insurance program must be strengthened to (a) provide strong disincentives to termination of pensions plans by requiring solvent employers who terminate pension plans to be responsible for the full amount of accrued benefits of plan participants, and

> (b) curtail the ability of employers to dump unfunded pension liabilities on the Pension Benefit Guaranty Corporation. We will oppose attempts to modify the Multi-Employer Pension Plan Amendments of 1980.

The AFL-CIO is convinced that the nation can move toward full employment, restore fairness and build a better tomorrow for ourselves and our children. The program we have outlined will move the country toward these goals and at the same time reduce the federal deficit by stimulating the economy and raising needed revenues.

Congress should start to deal with these issues now, but only with the election of a new Administration can these principles be achieved.

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Attachments: Background Paper

Background Paper on The National Economy

The Administration proposes to increase defense outlays in 1985 to $272 billion, an increase of 15 percent.

This Council has called for reducing real defense spending increases to a range of 5 to 7 percent, with some members urging that the increase be held to the lower end of the range or below.

Savings from this lowered defense spending would be $7 to $12 billion in the first year, with substantially greater reductions in future years, assuming an inflation rate of 5 percent.

To pay for real increases in defense spending, we have supported a progressive surtax levied on corporate and individual income taxes, plus an additional tax on income currently sheltered. Such a surtax would raise $12 billion to $17 billion in the first year.

A number of the programs that the AFL-CIO calls for would provide for increased expenditures. But to the extent that people are put back to work under these programs, they would become taxpayers rather than recipients of unemployment compensation or in some cases welfare benefits. Each one-percent reduction of unemployment raises tax revenues by about $25 billion and reduces outlays by $5 billion.

Following are the budget estimates for the detailed programs spelled out in the AFL-CIO recommendations:

The Industrial Policy Act (H.R. 4360) would set up a new process for dealing with industrial economic issues through a new Council on Industrial Competitiveness, whose cost would be small. The Bank for Industrial Competitiveness would have a federal authorization for $8.5 billion in federal stock subscription made available over several years.

The Community Service Jobs Act (H.R. 1036 and S. 1812) calls for an authorization of $3.5 billion to employ people in community service work who cannot find jobs in the private sector .

The Public Works Act (H.R. 2544) would carry an authorization of $3.2 billion to help reconstruct the nation's basic infrastructure, including water and sewer facilities, highways and port facilities, and other public works which stimulate private, job-creating investment and economic activity.

The Plant Closing Act (H.R. 2847) would have little budget impact; it would require employers to provide advance notice and some basic protections for workers and local communities.

The domestic auto content bill (H.R. 1234 and S. 707) would have no measurable budget outlays but would assure continued extensive U.S.auto production.

The Health Care Protection Bill (H.R. 3321) calls for authorization of $1.8 billion a year for each of two years to provide health insurance coverage for the unemployed.

The health care cost containment legislation would save the federal government $1 billion. We oppose the President's call for cuts of $1.1 billion in Medicare and $1.1 billion in Medicaid.

The energy bills, women's pension and insurance protections, consumer and worker protections in telephone, and consumer and worker protections in bankruptcy have little budget impact, but provide substantial worker and consumer safeguards.

We are opposed to the President's call for cuts of $200 million in authorization for elementary, secondary and vocational education and for cuts of $900 million in higher education loans and grants.

We are opposed to the President's call for cuts of $600 million in employment and training programs.

There is a saving to the government in our proposals for improving the single-employer pension guarantee program.

In addition, the AFL-CIO has proposed a second rollback of the personal and corporate income tax reductions enacted in 1981, and the closing of some earlier corporate tax loopholes, which would add up to an estimated $49 billion in additional tax revenues in fiscal year 1985.

This is just a partial recapture of the $165 billion in revenue loss that occurs in 1985 as a result of the 1981 Tax Act. Congress made a start in 1982 to correct this revenue shortfall problem.

Additional Federal Revenues From AFL-CIO Tax Proposals

	Fiscal Year 1985 in Billions
$700 Cap -- Third Year	$ 6.9
Repeal Indexing	6.2
Trim "Savings" Exclusions	2.7
Phase Down Capital Gains	3.9
Scale Back Estate and Gift Exclusion	3.7
Foreign Tax:	
DISC	1.4
Deferral	1.0
Foreign Tax Credit	7.1
Investment Tax Credit:	
Depreciation Basis Adjustment	1.3
Reduce 10% to 7%	7.1
Limit Graduate Rates to Small Corporations	2.0
Oil and Gas Depletion & Expensing of Drilling Costs	6.0
	$49.3

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